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hearing entitled

"Regulatory Whiplash: Examining the Impact of FSOC's Ever-changing Designation Framework on Innovation"

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Chairman Hill, Ranking Member Lynch, and Members of the Subcommittee, thank you for inviting me to testify today.

My name is Jeffrey Dinwoodie. I am a partner at the law firm of Cravath, Swaine & Moore LLP. Today I am presenting my own views, and not those of my firm or any client of the firm.

Background and Perspective

My testimony and the views I will express today are informed by my fifteen years of experience working on regulation, compliance and transactions involving financial institutions and markets. This includes eight years in the private sector and seven years (over two different stints) in government.

My practice at Cravath focuses on advising financial institutions and companies on transactions, the development of new products, regulatory and compliance issues and policy initiatives. My clients include established institutions as well as entrepreneurs and emerging companies seeking to bring innovative products and technologies to market.

From June 2017 to June 2021, I had the privilege of serving at the U.S. Department of the Treasury (the "Treasury Department" or "Treasury") and the Securities and Exchange Commission (the "SEC"). At Treasury, I served as the Principal Deputy Assistant Secretary for Financial Institutions. I managed offices focused on regulatory and policy issues in the areas of banking, insurance, fintech/digital assets and community and economic development.

At the SEC, I served in several capacities, including as Chairman Jay Clayton's Chief Counsel and, earlier, as Chairman Clayton's Trading and Markets Counsel. I also served as the SEC's Deputy Representative to the Financial Stability Oversight Council ("FSOC" or the "Council"), and as the SEC's Senior Policy Advisor for Market and Activities-Based Risk. In these roles, I managed and coordinated the SEC's efforts to prepare for and respond to emerging market risks, working closely with leadership and staff at the other federal regulators. I was also a member of the SEC's COVID-19 Market Monitoring Group, a senior-level group that managed the agency's response to COVID-19.

Earlier in my career, between 2008 and 2011, I was an attorney in the SEC's Division of Trading and Markets. I spent a significant portion of that time on Financial Crisis-related issues. I served as a core member of the SEC's Dodd-Frank Implementation Team, with a focus on the Title VII derivatives provisions.

My testimony is divided into two parts. The first provides background and context regarding FSOC, including its structure, powers and history. In the second part, I provide perspectives on (1) the important role that Congress has assigned to FSOC, (2) the authority that Congress provided to FSOC to designate nonbank financial companies as "systemically important financial institutions" ("nonbank SIFIs") and (3) FSOC's focus and agenda going forward.

Part I. FSOC: Background and Context

A. Structure and Purposes

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or "Dodd-Frank") created FSOC to identify risks to U.S. financial stability, promote market discipline and respond to emerging threats to the stability of the U.S. financial system. By statute, FSOC is chaired by the Secretary of the Treasury and consists of 10 voting members (generally, the heads of the federal financial regulatory agencies) and five nonvoting members.

The Dodd-Frank Act assigned FSOC specific duties, which can generally be categorized into regulatory coordination duties and financial stability-related duties. FSOC's regulatory coordination duties include, for example, (1) facilitating information sharing and coordination among FSOC member agencies, (2) recommending to FSOC member agencies general supervisory priorities and principles reflecting FSOC discussions and (3) providing a forum for resolving jurisdictional disputes among FSOC members.

FSOC's financial stability duties include, for example, (1) monitoring the financial services marketplace for potential threats to U.S. financial stability, (2) identifying gaps in regulation that could pose risks to U.S. financial stability, (3) issuing formal public (but not binding) recommendations to primary financial regulatory agencies concerning new or heightened standards and safeguards and (4) reporting annually to Congress on FSOC's activities and potential emerging threats to U.S. financial stability, among other things.

Dodd-Frank also provided FSOC with designation authorities. The first—FSOC's authority to designate nonbank financial companies as nonbank SIFIs—is widely followed and has had a controversial history. The second—FSOC's authority to designate "financial market utilities" ("FMUs") and "payment, clearing or settlement activities" that FSOC determines are, or are likely to become, systemically important—is commonly overlooked.

B. Nonbank SIFI Designation Authority

Section 113 of Dodd-Frank provides FSOC with authority to designate a nonbank financial company for Federal Reserve supervision and prudential standards, if FSOC determines that material financial distress at the company, or the nature, scope, size, scale, concentration, interconnectedness or mix of the activities of the company, could pose a threat to U.S. financial stability.

FSOC's approach to and use of its nonbank SIFI designation authority has, as noted, been controversial over the years—and has evolved. In 2012, FSOC issued a final rule and interpretive guidance describing its procedures and approach to nonbank SIFI designations.[1] Between 2013 and 2014, FSOC designated four nonbank SIFIs: American

[1] *See* "Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies," 77 Fed. Reg. 21637 (Apr. 11, 2012), *available at*

International Group, Inc. ("AIG"), GE Capital Global Holdings, LLC ("GE Capital"), Prudential Financial, Inc. ("Prudential") and MetLife, Inc. ("MetLife"). In March 2016, a federal district court rescinded MetLife's designation. Following the change in Presidential administration, the U.S. government dropped its appeal of that decision. FSOC rescinded the designations of GE Capital, AIG and Prudential in 2016, 2017 and 2018, respectively. No companies are currently designated as nonbank SIFIs.

Over the years, various criticisms have been levied at FSOC's nonbank SIFI designation process and analytical approach, including by the U.S. Government Accountability Office in a 2014 report, members of Congress and the MetLife court, among others.[2]

In April 2017, President Trump directed the Treasury Department to review the nonbank SIFI designation process and develop recommendations to improve it, culminating in the Treasury Department's publication of a formal report later that year.[3]

In December 2019, FSOC adopted guidance that prioritized an "activities-based approach" to monitoring and addressing systemic risk.[4] That guidance stated that FSOC would prioritize its efforts to identify, assess and address potential risks and threats to U.S. financial stability through an "activities-based approach."[5] The 2019 guidance explained that FSOC expected to use nonbank SIFI designations as a last resort: "only if a potential risk or threat cannot be adequately addressed through an activities-based approach."[6] The activities-based approach generally described FSOC's approach of examining a range of financial products, activities or practices that could pose risks to U.S. financial stability. If a potential risk to U.S. financial stability was identified, FSOC would work with federal and state financial regulators to seek the implementation of appropriate actions to address the potential risk.

The 2019 guidance also introduced other changes to FSOC's nonbank SIFI designation process. Most notably:

- *Cost-benefit requirement for designation authority*. The guidance required FSOC to conduct a cost-benefit analysis and then confirm—before making any nonbank SIFI designation—that the expected benefits to financial stability

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https://home.treasury.gov/system/files/261/Authority%20to%20Require%20Supervision%20and%20Regulation%20of%20Certain%20Nonbank%20Financial%20Companies%20%28April%2011%2C%202012%29.pdf.

[2] *See, e.g.*, U.S. Government Accountability Office, "Financial Stability Oversight Council: Further Actions Could Improve the Nonbank Designation Process" (Nov. 20, 2014), *available at* https://www.gao.gov/assets/gao-15-51.pdf; Financial Services Committee Chairman Jeb Hensarling, "Opening Statement at FSOC Oversight Hearing" (Sept. 22, 2016), *available at* https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=401068; *MetLife, Inc. v. Fin. Stability Oversight Council*, 177 F. Supp. 3d 219 (D.D.C. 2016).

[3] *See* Treasury Department, "Treasury Releases Memorandum to the President on FSOC's Designation Processes for Nonbank Financial Companies and Financial Market Utilities" (Nov. 17, 2017), *available at* https://home.treasury.gov/news/press-releases/sm0218.

[4] *See* "Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies," 84 Fed. Reg. 71740 (Dec. 30, 2019), *available at* https://home.treasury.gov/system/files/261/Authority-to-Require-Supervision-and-Regulation-of-Certain-Nonbank-Financial-Companies.pdf.

[5] *Id.* at 71740.

[6] *Id.* at 71742.

from an entity-based designation would justify any expected costs resulting from the designation.

- *Cost-benefit requirement for recommendation authority*. The guidance required FSOC, before using its recommendation authority, to ascertain whether the relevant financial regulatory agency would be expected to perform a cost-benefit analysis of the actions it would take in response to a contemplated FSOC recommendation. If such analysis is not expected, then FSOC would itself perform the cost-benefit analysis prior to making the recommendation.

- *Likelihood of material financial distress*. The guidance required FSOC to consider the likelihood of a nonbank financial company's material financial distress when making a designation determination—as opposed to merely assessing whether such distress could threaten financial stability.

- *Meaning of "threat to the financial stability of the United States."* The guidance interpreted this phrase, which is central to FSOC's designation authority, as meaning: the threat of an impairment of financial intermediation or of financial market functioning that would (not could) be sufficient to inflict severe damage on the broader economy.

In April 2023, FSOC proposed, and then in November 2023 finalized, new guidance to replace the 2019 guidance.[7] The new guidance eliminates the heightened procedural protections that FSOC adopted in 2019, described just above. This included:

- Moving away from approaching entity designation as a "tool of last resort"—and instead placing designation authority on "equal footing" with FSOC's other authorities;

- Removing the cost-benefit requirements associated with FSOC's use of its nonbank SIFI designation authority and its policy recommendation authority;

- Removing the requirement to assess the "likelihood" of a company's material financial distress prior to designation and

- Liberalizing the key designation threshold of "threat to the financial stability of the United States" by introducing a more speculative standard: Events or conditions that could substantially impair the ability of the financial system to support economic activity.

Under the 2023 guidance, it is significantly easier for FSOC to designate companies as nonbank SIFIs, if FSOC chooses to use this authority.

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[7] *See* "Guidance on Nonbank Financial Company Determinations," 88 Fed. Reg. 80110 (Nov. 17, 2023), *available at* https://home.treasury.gov/system/files/261/Interpretive-Guidance-Regarding-Authority-to-Require-Supervision-and-Regulation-of-Certain-Nonbank-Financial-Companies.pdf.

In explaining the change, FSOC stated that while the 2019 guidance provided "additional clarity" regarding the Council's procedures, it created "inappropriate hurdles" to FSOC's ability to use its nonbank SIFI designation authority.[8] FSOC also stated that it has used its nonbank SIFI designation authority "sparingly," but in order "to mitigate the risks of future financial crises, the Council must be able to use each of its statutory authorities as appropriate to address potential threats to U.S. financial stability."[9]

FSOC's replacement of its 2019 guidance did not come as a surprise to those who have been following this area. In a 2019 comment letter to FSOC regarding the proposal that ultimately became the 2019 guidance, then-private citizen—and now FSOC Chair and Treasury Secretary—Janet Yellen (and other former senior government officials) expressed concerns regarding the "activities-based approach," including that the activities-based approach would "neuter the designation authority."[10]

C. FMU and Payment, Clearing or Settlement Activity Designation Authority

Section 804 of the Dodd-Frank Act provides FSOC with authority to designate "FMUs" and "payment, clearing or settlement activities" that FSOC determines are, or are likely to become, systemically important. Title VIII of Dodd-Frank defines "systemically important" as a situation where the failure of or a disruption to the functioning of an FMU or the conduct of a payment, clearing or settlement activity could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the U.S. financial system.

Subject to exclusions, Title VIII defines an "FMU" as "any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person." Title VIII defines "payment, clearing, or settlement activity" to mean activity carried out by one or more financial institutions to facilitate the completion of financial transactions, subject to exclusions.

FSOC's designation of an FMU or payment, clearing or settlement activities by a financial institution as systemically important subjects the designated FMU or the designated activities to the requirements of Title VIII, which includes, among other things, heightened risk management standards and additional examinations and reporting requirements imposed by the Federal Reserve and/or the SEC or CFTC, as applicable.

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[8] *See* "Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies," 88 Fed. Reg. 26234 at 26235 (Apr. 28, 2023), *available at* https://home.treasury.gov/system/files/261/FSOC-2023-Proposed-Nonbanks-Guidance.pdf.

[9] *Id.*

[10] *See* Comment from former Chairs of the FSOC and two previous Chairs of the Federal Reserve Board, "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (RIN 4030-ZA00)" at 1 (May 13, 2019), *available at* https://www.regulations.gov/comment/FSOC-2019-0001-0010.

In 2011, FSOC finalized a rule describing the criteria, processes and procedures for FSOC's designation of FMUs as systemically important.[11] In July 2012, FSOC designated eight FMUs as systemically important under Title VIII: (1) The Clearing House Payments Company L.L.C. (on the basis of its role as operator of the Clearing House Interbank Payments System), (2) CLS Bank International, (3) Chicago Mercantile Exchange, Inc., (4) The Depository Trust Company, (5) Fixed Income Clearing Corporation, (6) ICE Clear Credit LLC, (7) National Securities Clearing Corporation and (8) The Options Clearing Corporation. Those designations remain in place.

Part II. Observations and Reflections

A. The Important Role and Function of FSOC

First, it is useful to recognize the important role and function that FSOC fulfills. The financial services sector and economy is vast and complex. In the United States, oversight over our economy and markets is divided across numerous regulatory organizations that have different governing statutes, missions and mandates. There is tremendous benefit in having a formal mechanism, FSOC, that is responsible for bringing together a broad group of subject matter experts to identify, monitor and spearhead responses to emerging risks across the financial system.

FSOC also serves as a catalyst for interagency coordination and cooperation. Relationships built through FSOC's work carry over generally to matters unrelated to FSOC. FSOC, together with the President's Working Group on Financial Markets ("PWG") and other interagency working groups, create valuable "connective tissue" across all levels of regulatory agencies that helps mitigate regulatory siloing that can occur across our multi-agency regulatory system.

Regulatory coordination and cooperation is critically important at all times, but is essential when crises occur. I experienced this first-hand when I was working at the SEC and the Treasury Department when the COVID-19 crisis struck.

In a November 2020 speech, then-SEC Chairman Jay Clayton reflected on his Chairmanship and observed that strong relationships that resulted from FSOC, the PWG and other bilateral and multilateral engagements:

> [E]stablished muscle memory [that regulators] relied upon extensively when we needed it most, including during the market shocks of March and April [2020] resulting from COVID-19. [The] professional and personal relationships established over the prior three years led to a more decisive, more unified, and ultimately more impactful response to the economic effects of COVID-19.[12]

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[11] *See* "Authority To Designate Financial Market Utilities as Systemically Important," 76 Fed. Reg. 44763 (July 27, 2011), *available at* https://www.govinfo.gov/content/pkg/FR-2011-07-27/pdf/2011-18948.pdf.

[12] Chairman Jay Clayton, "Putting Principles into Practice, the SEC from 2017–2020" (Nov. 19, 2020), *available at* https://www.sec.gov/news/speech/clayton-economic-club-ny-2020-11-19.

B. Nonbank "SIFI" Designations

Only time will tell what will be the practical effects of the Council's recent decision to (1) eliminate the procedural protections adopted in 2019 and (2) place FSOC's nonbank SIFI designation authority "on equal footing" with FSOC's other powers.

It is possible that the Council could proceed aggressively and begin to engage in numerous designation reviews across industries. But my hope is that the decision to place the nonbank SIFI designation authority "on equal footing" with FSOC's other powers proves in time to largely be only a symbolic change—and that nonbank SIFI designation remains, in practice, a tool of last resort. Indeed, it is difficult to understand how the SIFI designation of a company would be the most effective "first step" to address or respond to a perceived threat.

Under the Dodd-Frank Act, a company designated as a nonbank SIFI becomes subject to Federal Reserve supervision and prudential standards developed by the Federal Reserve. But it is unclear, for example, how designating an asset manager—and thereby subjecting it to Federal Reserve supervision and prudential standards—would reduce systemic risk. This would be a peculiar approach, given that the Federal Reserve does not actually have any demonstrable expertise or experience in the asset management industry. These questions also apply in the context of many other types of companies, such as digital asset-focused companies and financial technology companies, where it may not be clear that the Federal Reserve has the requisite expertise or experience in the given industry and/or that out of all U.S. regulatory authorities, the Federal Reserve is the best-positioned to supervise that company.

This approach may also actually *increase* systemic risk because, among other reasons, it would distract Federal Reserve resources from that institution's core areas of focus: the banking system and monetary policy.

Additionally, a nonbank SIFI designation would change the competitive landscape and could create distortions in the market and/or broader economy, in a myriad of potential ways.[13] For instance, on the one hand, a designation could harm the designated company's competitive position because of the compliance costs and burdens that would be associated with Federal Reserve supervision and prudential standards.[14] Alternatively, and ironically, it is possible that a designation could ultimately provide a competitive advantage for a designated company, on the basis that the designation could be perceived as an implicit U.S. government guarantee.[15]

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[13] *See* Comment from the Asset Management Group of the Securities Industry and Financial Markets Association on "Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies; RIN 4030-[XXXX] & Analytic Framework for Financial Stability Risk Identification, Assessment, and Response; RIN 4030-[XXXX]" at 12-13 (July 27, 2023), *available at* https://www.regulations.gov/comment/FSOC-2023-0002-0048.

[14] See *id.*

[15] See *id.*

Stepping back, and from a common-sense perspective, the most effective approach to identifying and addressing potential risks to U.S. financial stability is an activities-based approach, whereby FSOC focuses its efforts on industry- and economy-wide assessments, and works closely with Congress and relevant regulators to respond to any perceived threat. This approach best leverages the skills and experience of the organizations and individuals that have the most expertise in the given domain.

Almost everyone agrees that designation is a blunt regulatory instrument that should only be used as a backstop: for example, after the Council has conducted an activities-based review, determined that a threat exists that meets the statutory standard, raised the issue to Congress and/or the relevant regulatory authorities—and there has been a failure to act.

It is heartening that FSOC has noted that its new guidance does not make designation FSOC's "default" method of addressing risks to financial stability. FSOC has stated that it expects to continue to address most risks—as has been the case in recent years—through its collaboration with primary financial regulators. Let's hope this remains the case.

C. Areas of Focus

Because FSOC and its member agencies have finite resources to bring to bear on FSOC's important mission, it is imperative that the Council remain disciplined in its approach. FSOC should resist any attempts to be used to advance policy or regulatory agendas (or narratives in support of such agendas) that are unrelated to FSOC's financial stability and regulatory coordination mandates.

In FSOC's 2023 Annual Report (the "2023 Annual Report"), which it published six weeks after finalizing the 2023 guidance, FSOC for the first time identified the use of artificial intelligence ("AI") in financial services as an "emerging vulnerability" in the financial system.[16] The 2023 Annual Report states that AI can "introduce certain risks, including safety-and-soundness risks like cyber and model risks."[17] It further states that "without proper design, testing, and controls, AI can lead to disparate outcomes, which may cause direct consumer harm and/or raise consumer compliance risks."[18]

The possibility of safety-and-soundness risks at financial institutions is a topic within FSOC's remit. But it is unclear how potential "disparate outcomes" and "consumer compliance risks" associated with AI are relevant to FSOC's mandates. Disparate outcomes and consumer compliance risks are topics that policymakers and regulators can and should examine, but it is difficult to understand how they fit within FSOC's remit.

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[16] *See* FSOC, "Annual Report 2023" at 9 (Dec. 14, 2023), *available at* https://home.treasury.gov/system/files/261/FSOC2023AnnualReport.pdf.
[17] *Id.* at 91.
[18] *Id.* at 92.

At the same time, FSOC must stay focused on providing a sober and realistic assessment of the factors and areas that truly present vulnerabilities, risks and threats to U.S. financial stability. In its 2023 Annual Report, FSOC identified its four priority areas: (1) nonbank financial intermediation, (2) Treasury market resilience, (3) climate-related financial risk and (4) digital assets. The 2023 Annual Report also identified the Council's six staff-level committees: (1) the Systemic Risk Committee, (2) the Financial Market Utilities and Payment, Clearing, and Settlement Activities Committee, (3) the Nonbank Financial Companies Designations Committee, (4) the Regulation and Resolution Committee, (5) the Climate-related Financial Risk Committee and (6) the Data Committee.

But based on the Annual Report, it appears that FSOC is not currently focusing on the vulnerabilities and risks that emanate from the government and state actors. Make no mistake, vulnerabilities and risks to financial stability are not limited to private sector actors and forces. Government and state actors, actions and policies create risks and vulnerabilities—and should be examined.

To name just one example, many concerns have been raised regarding potential effects on the financial services sector and broader economy of the large volume of financial regulatory rulemaking initiatives advanced over the past three years.[19] Given the number of wide-ranging proposals, and the questions raised concerning their potential cumulative effects, this is a topic that FSOC should be examining and monitoring.

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Thank you again for the opportunity to participate today. I look forward to addressing any questions you may have.

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[19] *See, e.g.*, Dalia O. Blass, "Examining the SEC's Agenda: Unintended Consequences for U.S. Capital Markets and Investors" (Nov. 2, 2023), *available at* https://docs.house.gov/meetings/BA/BA16/20231102/116527/HHRG-118-BA16-Wstate-BlassD-20231102.pdf ("Many of the [SEC's] proposals fail to show an accurate understanding of the markets or the participants they seek to regulate. . . . Many do not reflect how intermediaries operate nor how the interconnections among them will cumulatively affect the operation and function of our capital markets. If adopted and allowed to take effect, I believe that they could disrupt the operation and efficiency of our capital markets.").