Statement of Bill Hulse, Senior Vice President, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce

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

January 10, 2024

Chairman Hill, Ranking Member Lynch, and Members of the House Financial Services Subcommittee on Digital Assets, Financial Technology and Inclusion, thank you for this opportunity to testify today regarding the analytic framework and interpretive guidance for the designation of non-bank financial institutions recently adopted by the Financial Stability Oversight Council (FSOC or Council).

Since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in 2010, the Chamber has supported FSOC's close adherence to the Congressional mandate contained in Section 113 of Dodd-Frank. In the years immediately following passage of Dodd-Frank, FSOC strayed from that mandate when it embarked down a path of designating institutions for enhanced supervision by the Federal Reserve without first conducting a substantive economic analysis and assessing the impact that such designations would have on financial stability and the broader economy.

In response to this departure from Congressional intent, the Chamber released an FSOC Reform Agenda in 2013 that proposed several transparency, due process, and data-driven approaches that would assist FSOC in fulfilling its important mission.[1] Unfortunately, these ideas were largely ignored by then-FSOC members, and FSOC's flawed view of systemic risk supervision was eventually struck down by the courts in the 2016 *MetLife* decision.[2] In that decision, the U.S. District Court for the District of Columbia found that FSOC assumed the benefits of designation to MetLife but not the costs, and also failed to follow FSOC's own guidance throughout the designation process.

In response to the *MetLife* decision and to the due process and procedural concerns raised by market participants and members of Congress, in 2019 FSOC adopted new interpretive guidance that emphasized an activities-based (rather than firm-centric) approach to systemic risk supervision.[3] This guidance memorialized a direction of travel expressed by the Treasury Department under the leadership of Secretary Lew to prioritize focusing on "industry-wide products and activities."[4] The Chamber strongly supported this guidance as it appropriately balanced concerns over financial stability in the United States while ensuring due process for any nonbank financial company that might be under consideration for heightened supervision. The

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[1] See Financial Stability Oversight Council Reform Agenda found at: https://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/2013_Financial-Stability-Oversight-Council-Reform-Agenda.pdf

[2] MetLife, Inc. v. FSOC, 177 F. Supp. 3d 219 (D.D.C. 2016)

[3] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 84 Fed. Reg. 71,740 (Dec. 30, 2019)

[4] https://home.treasury.gov/news/press-releases/jl0431

2019 guidance also stipulated that FSOC consider alternative methods prior to designating any activity or institution as systemically important.

During her confirmation hearing in January 2021, Secretary Yellen indicated support for an activities-based approach by FSOC, stating: "When I served on FSOC as Fed Chair, it was proposed to look at activities that asset managers engage in that might pose systemic risks.…this is an activities-based approach that FSOC was pursuing. And I thought that was the right approach. So…I would hope to look again at some of those approaches."[5] Several bipartisan bills over the last decade have also sought to move FSOC away from the "designate-first" mentality that was at the heart of the *MetLife* decision.[6]

It is critical to understand that the 2019 guidance was in effect during the extreme market stress experienced at the onset of the COVID-19 pandemic in the Spring of 2020. It was also in effect during the collapse of Silicon Valley Bank (SVB) and the volatility in the financial system that occurred in 2023. None of these episodes lent itself to any type of credible argument that FSOC or the prudential regulators lack sufficient authority to address these types of events, or that the 2019 guidance weakened FSOC's ability to respond to or oversee potential systemic threats to the financial system. Further, under the 2019 guidance, two-thirds of the voting FSOC members would have been able to address any emergency risks to financial stability.

Notwithstanding the careful and deliberative process in which the activities-based approach was adopted as part of the 2019 guidance, FSOC has regressed by adopting guidance and an analytic framework that are curiously similar to FSOC's procedures that were in place prior to the *MetLife* decision. Despite FSOC's assertion that the activities-based approach remains a part of its toolbox, we remain deeply concerned that the unnecessary changes to its procedures reflects FSOC's intention to make designation its primary approach, particularly when at least one FSOC voting member has commented that the fact that no nonbanks are currently designated is a sign of FSOC's failure.[7]

Furthermore, although nonbanks had structured their businesses in reliance on the clear factors of the 2019 guidance, FSOC's new policies now fail to provide market participants with any meaningful direction on FSOC's designation process or analytical process, or fair notice on standards that would apply if a nonbank were designated. This will disincentive nonbanks – in particular fintech and other new entrants to the financial markets – from engaging in new ideas or developing innovative products, resulting in an increase in homogeneity across the financial system and, paradoxically, could actually *contribute* to greater systemic risk.

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[5] U.S. Senate Committee on Finance, Hearing to Consider the Anticipated Nomination of the Honorable Janet L. Yellen to the Secretary of the Treasury, January 19, 2021, available at https://www.congress.gov/117/chrg/CHRG-117shrg46951/CHRG-117shrg46951.pdf

[6] H.R. 3812, Financial Stability Oversight Council Improvement Act of 2023; S. 603 (116th Congress); H.R. 4061 (115th Congress)

[7] Rohit Chopra, *Statement of CFRB Director Rohit Chopra on the Proposed Restoration of the Financial Stability Oversight Council's Authority and Regulatory Credibility*, CFRB (Apr. 21, 2023), https://www.consumerfinance.gov/about-us/newsroom/statement-of-cfpb-director-rohit-chopra-on-proposed-restoration-of-financial-stability-oversight-council-authority-regulatory-credibility/

More fundamentally, the new guidance and framework issued by FSOC is part and parcel of the current incoherent approach to regulation and systemic supervision by federal financial regulators. FSOC's policies have been approved at the same time that prudential regulators are considering their final Basel III proposal, which could ultimately increase capital requirements for some banks by more than twenty percent and which would undoubtedly have a major impact on credit availability for consumers and businesses.[8]

To current FSOC members virtually *everything* – nonbanks, banks, digital assets, artificial intelligence and other risks – are a potential systemic threat to the financial system. Federal Deposit Insurance Corporation (FDIC) Chair Gruenberg recently acknowledged that the Basel III proposal could lead to a migration of activity out of banks and into the nonbank financial system. Without a hint of irony, Chair Gruenberg in the same speech then argued that the same regulators whose actions would be the cause of this likely migration must therefore possess greater authority over nonbanks.[9]

It is little surprise that the actual risks that caused the SVB and regional bank crisis last year – interest rate risk and depositor concentration – were nowhere near the top of the list of highest risks identified by FSOC.[10] Further, the Federal Reserve Inspector General report regarding the failure of SVB found that prior to SVB's collapse, Federal Reserve supervisors "tend[ed] to take a forward-looking approach and [focus] on risk management and associated processes more than financial results."[11] The IG report also discovered that supervisors were "highlighting risk management deficiencies when more serious problems were emerging and [supervisors] missed the deficiencies in the bank's financial condition."[12]

Rather than addressing these supervisory failures and improving the processes by which regulators identify potential systemic threats, FSOC has now granted more authority to itself and the individual regulators that comprise the FSOC to impose new, yet-to-be seen standards on nonbanks that are ostensibly designed to make the financial system safer. Until the new guidance and analytic framework are rescinded and the 2019 guidance is restored, the Chamber fears that

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[8] How New Banking Rules Might Harm Your Business, U.S. Chamber blog: https://www.uschamber.com/finance/how-new-banking-rules-might-harm-your-business

[9] FDIC Chair Gruenberg remarks before the Exchequer Club (September 20, 2023): "Some have criticized the proposed higher capital requirements for large banks, arguing that higher capital charges on activities in banks would cause those activities to migrate to the more lightly regulated "shadow banks" and cause greater risk to the system. **The obvious response to that is there should be appropriately strong capital requirements for those activities in the banks, complemented by greater transparency, stronger oversight and appropriate prudential requirements for nonbanks** (emphasis added)**.** That would be the most effective and balanced way to enhance the stability of the entire financial system." https://www.fdic.gov/news/speeches/2023/spsept2023.html

[10] See 2022 top four risk priorities identified by FSOC: nonbank financial intermediation, climate-related financial risk, treasury market resilience, digital assets. https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc#:~:text=In%202021%2C%20the%20Council%20identified,risks%20related%20to%20digital%20assets .

[11] Material Loss Review of Silicon Valley Bank. Board of Governors of the Federal Reserve System Inspector General. (September 25, 2023) Available at https://oig.federalreserve.gov/reports/board-material-loss-review-silicon-valley-bank-sep2023.pdf?utm_source=substack&utm_medium=email

[12] *Id.*

FSOC will suffer the same credibility and legal deficiencies that existed leading up to the *MetLife* decision.

The Chamber is also concerned that until Congress passes legislation that provides for clear authorization and principled standards for the regulation of stablecoins, FSOC may try to use the new guidance and analytic framework to inappropriately intervene in the stablecoin and digital asset markets. Not only would such an intervention be legally questionable, it would impose regulatory overkill on nascent industries and technologies that are not systemically risky and weaken the competitiveness of the U.S. capital markets relative to other countries. Identifying ambiguity in the applicability of certain regulations to digital assets, or even a gap in such regulations, is not appropriate justification for designating individual companies as "systemically important." Imposing macro-prudential requirements to address gaps in regulatory policy for digital assets makes use of a bludgeon when a scalpel would do.

Bank-like regulation imposed by FSOC and administered by the Federal Reserve Board should not be treated as a panacea for addressing all perceived risks in the financial system or potential gaps in regulation. Bank regulation is designed for financial companies that generally have different assets and liabilities than nonbanks. Therefore, imposing bank-like regulation on a company would change the economics of its balance sheet and the products it can make available to the market.

Our specific concerns regarding these newly adopted policies are outlined in further detail below. Given that the final guidance and analytic framework is substantially the same as what FSOC proposed in April 2023, this testimony largely focuses on the key concerns articulated in the Chamber's July 2023 comment letter to FSOC.[13]

FSOC's Recent Actions Are Not Grounded in Statutory Authority

FSOC's sudden turnaround from the 2019 guidance does not comport with FSOC's authority under the Dodd-Frank Act. ***First,*** as the court held in the *MetLife* decision, Section 113 requires FSOC to consider costs before designating a nonbank financial company for heightened supervision. ***Second,*** Dodd-Frank also requires FSOC to consider a nonbank's vulnerability to "material financial distress" in the designation process. ***Third,*** as discussed in the *MetLife* decision, FSOC must consider nonbank financial companies' reliance interests before it departs from the 2019 guidance. ***Fourth,*** FSOC must consider alternatives before resorting to its extraordinary designation authority, including by relying on primary regulators. ***Fifth,*** FSOC must provide fair notice of how it plans to enforce Section 113 and which prudential standards would apply after a designation.

FSOC Must Consider Costs Before Designating a Nonbank for Supervision

Section 113(a)(2)(K) of Dodd-Frank requires that FSOC "shall consider any other risk-related factors that the Council deems appropriate in designating a nonbank for supervision. As the Supreme Court explained in *Michigan v. EPA,* the word "appropriate" is "the classic broad and

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[13] https://www.centerforcapitalmarkets.com/wp-content/uploads/2023/07/U.S.-Chamber-of-Commerce-Final-Comments_Nonbank_StabilityRisk-FSOC.pdf?

all-encompassing term that naturally and traditionally includes consideration of all the relevant factors."[14] In rescinding FSOC's designation of MetLife, the district court persuasively explained that Section 114(a)(2)(K) requires FSOC to consider the costs of designating a nonbank for supervision. As in the Supreme Court decision in *Michigan v. EPA,* the district court explained that the term "appropriate" is "the touchstone of the catch-all factor in Dodd-Frank Section 113."[15] Inexplicably, FSOC appears to have to completely ignored the lessons that should have been learned from the *MetLife* decision and removed what it deemed an "inappropriate prerequisite" to conduct a cost-benefit analysis prior to designating a nonbank financial company.

FSOC states that a pre-designation cost-benefit analysis would be "impossible to perform with reasonable precision."[16] However, agencies regularly analyze the costs and benefits of their decisions in any number of different contexts. For decades, across administrations of both parties, the executive branch has generally expected agencies consider both the costs and benefits of agency action (or inaction) throughout the rulemaking process.[17] Neither measuring difficulties nor the magnitude of harm associated with a financial crisis suggests a cost-benefit analysis is "impossible" to perform in conjunction with a nonbank designation. Indeed, FSOC undermined its own argument when it suggested that its proposal for guidance regarding nonbank designations was subject to Executive Order 12866 which directs agencies to "assess all costs and benefits of available regulatory alternatives, including the alternative of not regulating."[18]

The Council's sole member with insurance expertise emphasized the importance and historic relevance of cost-benefit analysis during the November 3, 2023 FSOC meeting.[19] The same member also discussed the importance of FSOC engaging with primary regulators to address potential threats, in particular state regulators that oversee insurance providers.

FSOC Must Consider Vulnerability to Material Financial Distress Before Designating a Nonbank for Supervision

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[14] Michigan v. EPA, 576 U.S. 743, 752 (2015)
[15] MetLife, 177 F. Supp. 3d at 240
[16] 88 Fed. Reg. 80,122
[17] See e.g. Exec Order No. 12,291, 46 Fed. Reg. 13,193 (Feb. 17, 1981); Exec. Order No. 13,563, 76 Fed. Reg. 3821 (Jan. 18, 2011) Exec. Order No 12,866, 58 Fed. Reg. 51,735 (Sept. 30, 1993)
[18] Exec. Order No. 12,866, 58 Fed. Reg. 51,735.
[19] See minutes on comments from Thomas Workman, FSOC Independent Member with Insurance Expertise: Regarding cost-benefit analysis, he said that, consistent with the logic of making all the tools available to plainly examine a risk and design a response, conducting a cost-benefit analysis can be an important tool in the analytical process prior to making a determination. He said that cost-benefit analysis is a tool that is well-recognized in federal and state statutory, regulatory, and case law, and is generally understood by the public as a way to make efficient use of government and private resources. He stated that, in light of the significant attention given cost-benefit analysis in the comments received, consideration should be given to having the Council deem the cost of designation to be an appropriate risk-related factor. He said that while it may be difficult to calculate the benefit of a designation in a given case, calculating the cost of a designation could provide valuable information about the cost that would be imposed on the designee.
https://home.treasury.gov/system/files/261/FSOC_20231103_Minutes.pdf

Five key factors within Section 113 make it abundantly clear that FSOC must consider vulnerability to material financial distress before designating a nonbank for supervision under this standard. By definition, a nonbank cannot pose a threat to the financial stability of the United States if it is not vulnerable to material financial distress. By presupposing the satisfaction of this statutory prerequisite to designation, FSOC is removing an important statutory constraint on its regulatory authority.

Congress' use of the word "material" to modify the phrase "financial distress" under Section 113 is important. The use of the word "material" means that the Council must consider whether the company is vulnerable based on an assessment of the company's particular circumstances. If the company's particular circumstances reveal the company is not vulnerable to a material level of financial distress, the company could not be designated for supervision. Congress also directed under Section 113 that FSOC consider particular factors relevant to a company, including the company's leverage, balance sheet exposures, relationships, amount and nature of financial assets, and liabilities. By directing FSOC to consider these company-specific factors, Congress required that FSOC consider the likelihood that the company will suffer material financial distress.

FSOC's approach under the recently finalized guidance means that if a company is engaged in financial activities and is large or prominent enough to be on the Council's radar for designation, on those bases alone it may be subjected to the economic and regulatory burdens resulting from designation since, pursuant to FSOC's view, they may always presuppose a company's material financial distress without the need to conduct any qualitative or quantitative analysis. Had Congress intended for size to be the sole threshold for designation, it would not have conditioned designation on the factors included under Section 113. Indeed, the company-specific factors in Section 113(a)(3) would serve no purpose if FSOC could designate a company for supervision merely based on a company's "importance" to the financial system.[20]

If hypothetical financial distress of any large company with extensive financial or customer relationships can simply be assumed, and the only other qualification for designation is that the company be engaged in financial activities, Section 113 would have marked a sea change in financial regulation. To the contrary, Congress would have spoken clearly if it intended to delegate to FSOC the extraordinary power to designate any large nonbank for supervision at any time, and for any reason, regardless of its vulnerability to financial distress.

FSOC Must Consider Reliance Interests Before Departing From Its Guidance

In addition to ignoring costs and vulnerability to material financial distress, FSOC has also ignored an important consideration that the Supreme Court has directed agencies to consider whenever they change policies. Although FSOC acknowledges that its recent guidance and analytic framework depart from the 2019 guidance, it fails to consider the extent to which nonbanks structured their affairs in reliance upon the 2019 guidance. Nonbank financial

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[20] 12 U.S.C. § 5323(a)(2)(D)–(E).

companies continue to be subject to "regulatory whiplash" as a result of FSOC's failing to consider their interest in relying on existing guidance.

The *MetLife* decision again illustrates the flaw in FSOC's process. The district court not only faulted FSOC for acting "contrary to" its own guidance, but also criticized FSOC for failing to consider MetLife's reliance interests on that guidance.[21] According to the decision, MetLife relied on the Guidance for years, including in multiple submissions to FSOC, before finding out that FSOC had inexplicably changed its approach."[22]

FSOC has very likely made the same mistake here by ignoring the extent to which nonbank financial companies have already structured their affairs in reliance upon the 2019 guidance. Nonbank financial companies across a variety of industry sectors have on their own initiative—or in coordination with their primary regulators—made changes to enhance their resilience and resolvability. Efforts to increase resilience include raising capital and enhancing enterprise-wide risk management as part of more holistic approaches to holding company oversight of operating subsidiaries.

Many nonbanks have also simplified their legal entity structure to facilitate their resolvability and participated in efforts to enhance applicable insolvency frameworks both in the United States and abroad. Eliminating any assessment of the likelihood of material financial distress makes nonbanks' efforts to increase their resilience irrelevant. Efforts to improve nonbank resolvability are designed to minimize damage to the U.S. economy and have been undermined by the recently issued guidance and analytic framework.

FSOC Must Consider Alternatives to Entity-Based Designation

Although Section 113 authorizes FSOC to designate nonbank financial companies for supervision, using this extraordinary power is meant to be an exception to the general rule that nonbanks are not subject to bank-like supervision. The Administrative Procedure Act (APA) reinforces that FSOC should wield this power rarely, and only after considering other alternatives, including reliance upon the nonbank financial company's primary regulators. According to the Supreme Court, "when an agency rescinds a prior policy its reasoned analysis must consider the alternatives that are within the ambit of the existing policy."[23]

However, the newly issued guidance indicates that FSOC intends to wield Section 113 as a primary option without first considering alternatives to designation. The 2019 guidance explained that FSOC would primarily rely on federal and state regulators to address potential risks to financial stability with regard to institutions under their respective jurisdictions – a prudent approach that FSOC is now abandoning. This decision by FSOC does not, however, change the requirement under the APA that regulatory agencies including FSOC consider alternatives before resorting to entity-based designations. Additionally, Dodd-Frank itself requires FSOC to first consider how a nonbank is overseen by other regulators.[24]

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[21] *MetLife*, 177 F. Supp. at 239–40.
[22] *Id.* at 236 n.18
[23] *Regents*, 140 S. Ct. at 1913
[24] 12 U.S.C. §§ 5323(a)(2)(H), 5323(g), 5323(i)

FSOC can best accomplish its mission to identify and respond to threats to U.S. financial stability by relying on primary regulators as a first option, including by facilitating information sharing and coordination among and with primary federal and state regulators. Designating nonbank financial companies for bank-style regulation is an ineffective and burdensome exercise of governmental authority, which is why international coordinating bodies have largely moved on from nonbank designation as an effective or viable means of addressing systemic risk.[25] Primary regulators are best suited to monitor for and mitigate potential risks associated specifically with the products and industries they regulate. Especially in light of FSOC not providing a reasonable rationale for transitioning away from the current guidance, FSOC should thus consider alternatives before using its extraordinary designation authority.

FSOC Must Ensure the Designation Process Affords Due Process

The new nonbank guidance also raises substantial constitutional and due process concerns for entities because it eliminates the 2019 guidance definition of the critical statutory term "threat to the financial stability of the United States" and replaces it with a malleable interpretation that will make it difficult, if not impossible, for nonbanks to understand the actual reasons they are being considered for designation. FSOC redefines "threat to the financial stability of the United States" as a threat that "*could* substantially impair the financial system's ability to support economic activity,"[26] a highly subjective phrase that will encompass any number of 'threats' identified by FSOC. FSOC has chosen to leave nonbank financial companies in the dark about the standard that FSOC will apply in the designation process or the regulatory consequences of such a designation.

To avoid this problem, FSOC should reinstate the definition of a "threat to the financial stability of the United States" contained in the 2019 guidance.[27] This term must mean at least some non-trivial quantum of damage to the broader economy, otherwise the language is meaningless and will apply to almost any circumstance that FSOC decides to put under its microscope at any point in time. A nonbank that poses only trivial harm (or no harm) to the economy cannot in any reasonable interpretation be considered systemically important.

Additionally, FSOC has chosen not to identify the specific prudential standards that will apply to a nonbank at the time of designation. It is entirely inconsistent with due process to designate a nonbank first without first articulating the prudential standards that will be imposed. At a minimum, the Federal Reserve should provide information to FSOC about the prudential

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[25] The FSB endorses an improved framework for the assessment and mitigation of systemic risk in the insurance sector and discontinues annual identification of global systemically important insurers (G-SIIs) (December 9, 2022). https://www.fsb.org/2022/12/the-fsb-endorses-an-improved-framework-for-the-assessment-and-mitigation-of-systemic-risk-in-the-insurance-sector-and-discontinues-annual-identification-of-global-systemically-important-insurers/

[26] 88 Fed. Reg. 78,032

[27] The 2019 guidance defined "risk to financial stability" as "a risk of an event or development that could impair financial intermediation or financial market functioning to a degree that would be sufficient to inflict significant damage on the broader economy". https://home.treasury.gov/system/files/261/Interpretive-Guidance-on-Nonbank-Financial-Company-Determinations.pdf

requirements, other regulations, and estimated costs of designation to the Council *before* it votes on designation of a nonbank.

Additionally, as outlined in the Chamber's July 2023 letter, there are other due process reforms that FSOC should adopt, including:

1. FSOC principals should be required to vote to commence the review of a nonbank in Stage 1, in addition to voting to advance a nonbank to Stage 2;
2. FSOC should confer with a nonbank's primary regulator *before* proceeding with notice to a nonbank. FSOC should also provide the nonbank with the full evidentiary record to allow the nonbank a fair opportunity to respond to and/or correct the record;
3. During Stage 1, FSOC should not have the ability to request a "page-limited" summary from a nonbank for its submissions;
4. FSOC member agency staff, in addition to FSOC staff, should identify and be available to discuss any risks allegedly posed by nonbanks during Stage 1 as well as the factual predicate for such risks;
5. FSOC principals, individually or collectively, should be available to meet with nonbanks at every stage of the determination process;
6. FSOC should notify a nonbank financial company as soon as practicable but no later than within one business day of the result of its vote to advance the nonbank to Stage 2;
7. FSOC should provide the full evidentiary record to the nonbank at least 120 days prior to making a determination to designate the nonbank for heightened supervision;
8. The primary financial regulatory agency of a nonbank under review should be involved early and often in FSOC's review process, rather than consulted on an episodic basis;
9. FSOC should ensure appropriate confidentially protections are in place throughout the entire consideration and designation process; and
10. FSOC should have to make an affirmative and specific determination that that a successor nonbank remains a threat to U.S. financial stability.

Designating Nonbank Digital Asset Companies as Systemically Important Will Not Promote Regulatory Clarity

The Chamber released a report in 2021 calling for clarity and an update of regulations for digital assets. "Digital Assets: A Framework for Regulation to Maintain the United States' Status as an Innovation Leader," is intended to provide a roadmap to U.S. policymakers.[28] The report includes considerations for a digital asset framework with a particular focus on financial services regulatory regimes, because of their significant impact on digital assets and related blockchain innovation. A competitive and workable regulatory framework for digital assets is critical to the ability of the U.S. to attract the capital to fund this growing industry and for the promise of the technology to be realized.

We appreciate the work of this Committee to advance regulatory solutions to provide clarity for the regulation of digital assets. The Chamber supports proactive efforts to support payments that will enable it to flourish, all while maintaining guardrails for bad actors and preventing illicit

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[28] Digital Assets: A Framework for Regulation to Maintain the United States' Status as an Innovation Leader. (January 2021). U.S. Chamber of Commerce, Center for Capital Markets Competitiveness. https://www.uschamber.com/finance/promoting-innovation-the-promise-of-digital-assets

activity. Payments is an important function that must reach all facets of society – banked, underbanked, and unbanked. However, forcing all digital assets policy into banking regulation or a regime under FSOC risks choking off access and limiting competition within our financial system.

We value the bipartisan efforts of the House Financial Services Committee, the Administration, and other policymakers to devise a thoughtful regulatory framework for payment stablecoins. Businesses are in search of legal and regulatory clarity and may choose to relocate, or invest, in jurisdictions that offer such legal certainty. And consumers need to know that reasonable regulatory protections are in place. The Chamber believes Congress should enact legislation that provides for clear authorization and principled standards for the regulation of payment stablecoins that is appropriately tailored for their risk and novel advantages.[29]
FSOC should not threaten Congress with assertions that digital assets "could" pose "systemic risk" and the suggestion it may designate a nonbank financial company as systemically important as leverage for enacting its preferred legislation for addressing potential regulatory gaps for digital assets not directly connected to the stability of the global financial system. FSOC's 2023 Annual Report states "financial stability vulnerabilities may arise" as support for its recommendation that "Congress pass legislation to provide for the regulation of stablecoins and of the spot market for crypto-assets that are not securities."[30] Gaps in regulation – both real and perceived – do not in and of themselves cause "systemic risk." Policymakers should be careful to not conflate market conduct policy (e.g., disclosure requirements to promote consumer and/or investor protection) with systemic risk and macro-prudential policy (e.g., capital requirements, stress testing). The former relates to consumers being treated fairly in the marketplace; the latter relates to the collapse of the global financial system. These are both important considerations for the comprehensive regulation of our financial system, but the regulatory tools are not interchangeable.

Multiple large nonbank crypto companies with different models have failed in the last 18 months. The failure of large crypto companies in the past 18 months should invite action by policymakers interested in enacting a regulatory framework that promotes trust in the marketplace. But, none of these failures – including instances of fraud and other breaches of consumer trust – had a material effect on the "traditional financial system" or demonstrated material interconnectedness" that posed any risk of bringing down the entire system. Key financial regulators have notably declined to conclude that digital assets – specifically payment stablecoins – currently pose systemic risk to the global financial system.

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[29] https://www.centerforcapitalmarkets.com/wp-content/uploads/2023/07/230724_Testimony_StablecoinLegislation_HFSC.pdf?#

[30] See excerpt from Press Release regarding FSOC 2023 Annual Report. "*Digital Assets:* The Council notes that financial stability vulnerabilities may arise from crypto-asset price volatility, the market's high use of leverage, the level of interconnectedness within the industry, operational risks, and the risk of runs on crypto-asset platforms and stablecoins. Vulnerabilities may also arise from token ownership concentration, cybersecurity risks, and the proliferation of platforms acting outside of or out of compliance with applicable laws and regulations. The Council emphasizes the importance of agencies' continuing to enforce existing rules and regulations applicable to the crypto-asset ecosystem. The Council reiterates its recommendation that Congress pass legislation to provide for the regulation of stablecoins and of the spot market for crypto-assets that are not securities." https://home.treasury.gov/news/press-releases/jy1991

- Secretary Yellen: "Although I can't say that they've reached the scale right now where they're a financial stability concern, we're seeing Terra having broken the buck and Tether under some pressure as well...I wouldn't characterize it at this scale as a real threat to financial stability…"[31]
- Lael Brainard (in her capacity as Vice-Chair of the Federal Reserve Board): "Despite significant investor losses, the crypto financial system does not yet appear to be so large or so interconnected with the traditional financial system as to pose a systemic risk. So this is the right time to ensure that like risks are subject to like regulatory outcomes and like disclosure so as to help investors distinguish between genuine, responsible innovation and the false allure of seemingly easy returns that obscures significant risk."[32]
- Acting Comptroller Michael Hsu: "there has been no contagion from cryptocurrencies to traditional banking and finance."[33]

Legislative Proposals to Increase FSOC Accountability and Avoid "Regulatory Whiplash"

Congress has consistently expressed increased transparency, due-process, and accountability for the activities of FSOC. In multiple instances, Congress has recognized that the vast authority delegated to FSOC by the Dodd-Frank Act should be reexamined and subject to more limitations. Various legislative proposals have been introduced since the enactment of the Dodd-Frank Act that would change FSOC's budget or make statutory changes to the nonbank designation process. Notably, many of these legislative proposals have been bipartisan and have previously advanced out of the House Financial Services Committee with strong support.

More than ten years ago, the Chamber released a Financial Stability Oversight Council Reform Agenda that is relevant today.[34] The report calls for more clarity and due process before designations, improved accountability, increased transparency on metrics for systemic risk, tailoring of systemic risk regulations to fit specific industries, a path for de-designation, and strict confidentiality for companies subject to the designation process. Congress should revisit the bipartisan strides it made towards addressing these concerns.

The financial services industry, just like the rest of the business community, thrives when there is regulatory certainty. Under the status quo, nonbank financial companies must navigate an unpredictable FSOC decision-making process that could have a material impact on their business model. Subjecting a nonbank financial company to macro-prudential regulation administered by the Federal Reserve Board could require a company to fundamentally change nearly every major aspect of its balance sheet. Without transparency and due-process reforms that are codified *in*

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[31] https://www.cnbc.com/2022/05/13/regulators-anxious-about-stablecoins-like-tether-after-ust-collapse.html
[32] https://www.cnbc.com/2022/05/13/regulators-anxious-about-stablecoins-like-tether-after-ust-collapse.html
[33] After reminding the audience about these vulnerabilities, the acting comptroller said that thanks to the OCC's "careful and cautious" approach to banks seeking to engage in crypto activities, "there has been no contagion from cryptocurrencies to traditional banking and finance." According to him, no banks are under stress or even rumored to be under stress due to crypto exposure. https://www.pymnts.com/cpi_posts/occs-comptroller-crypto-economy-is-dependent-on-hype/
[34] https://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/2013_Financial-Stability-Oversight-Council-Reform-Agenda.pdf

statute, nonbank financial companies will continue to be subject to regulatory whiplash and the whims of FSOC's voting members.

The hallmark of bipartisan legislative reform efforts was the **Financial Stability Oversight Council Improvement Act of 2015.** The bill prescribes procedural requirements for proposed FSOC determinations and final decision-making, and provides a structured process for a company to be "dedesignated."[35] The legislation was cosponsored by 31 Democrats and 29 Republicans and was favorably reported by this Committee (44 yeas to 12 nays). Many of the Members supporting this legislation still serve on this Committee today, and many other bipartisan legislative proposals have been sponsored, including some that are currently pending before this Committee.

Pending Legislation Supported by the US Chamber of Commerce:

- **H.R. 3812, FSOC Improvement Act (Foster, Huizenga, Gottheimer).** To require FSOC to consider alternative approaches before determining that a U.S. nonbank financial company shall be supervised by the Board of Governors of the Federal Reserve System.[36]
- **H.R. 3466, To enhance Financial Stability Oversight Council transparency (Barr, Loudermilk).** This bill would enhance transparency surrounding FSOC activities and place any new FSOC budget requests onto appropriations. Currently FSOC is funded by increased fees charged at Treasury's discretion by the Office of Financial Research.[37]

The Chamber also supports legislation that would subject FSOC to the regular appropriations process. Despite the entity's momentous authority and weight with regard to financial regulation, there is relatively little oversight. Appropriate checks and balances lead to stronger and more effective agencies. This could be accomplished through legislation such as the "Financial Stability Oversight Council Reform Act (117th Congress).

- **Financial Stability Oversight Council Reform Act 117th Congress (Emmer).** To place the Financial Stability Oversight Council and the Office of Financial Research under the regular appropriations process, to provide for certain quarterly reporting and public notice and comment requirements for the Office of Financial Research, and for other purposes.

Conclusion

Thank you again for the opportunity to testify. As we have for over a decade, the Chamber looks forward to continuing to work with members of both parties on substantive FSOC reforms that enhance transparency and due process throughout the regulatory process.

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[35] https://www.congress.gov/bill/114th-congress/house-bill/1550?s=3&r=1&q=%7B%22search%22%3A%22%5C%22Financial+Stability+Oversight+Council+Improvement+Act+of+2015%5C%22%22%7D

[36] https://www.congress.gov/118/bills/hr3812/BILLS-118hr3812ih.pdf.

[37] https://www.congress.gov/bill/118th-congress/house-bill/3466/text?s=1&r=54