FSOC Shift to an Activities-Based Approach Signals an Emphasis on the Risks to Financial Stability from Digital Transformation

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The Financial Stability Oversight Council's (**FSOC**) recently revised guidelines (the **2019 Guidelines**)[1] on how it will identify and address financial stability risks are a major shift from the guidelines it issued in the immediate aftermath of the Financial Crisis (the **2012 Guidelines**). The 2019 Guidelines draw upon lessons learned from FSOC's ultimately fruitless attempts to designate nonbank financial companies as systematically important. Instead, building on one of the original purposes of the Dodd-Frank Act,[2] which was then emphasized in one of the Treasury Reports, the 2019 Guidelines focus on identifying and regulating systemically important activities rather than entities, conducting cost-benefit analyses, enhancing transparency and engagement in the nonbank SIFI designation process, and providing an off-ramp from designation for nonbank SIFIs. The 2019 Guidelines replace the 2012 Guidelines in their entirety and were adopted by FSOC with the aim of ensuring "that the [FSOC's] work is clear, transparent, and analytically rigorous, and . . . enhanc[ing] [FSOC's] engagement with companies, regulators and other stakeholders."

In addition to FSOC's authority under Section 113 of the Dodd-Frank Act to designate nonbank financial companies as systemically important, Section 120 provides for FSOC issuing recommendations to financial regulatory agencies to apply new or heightened standards and safeguards for a financial activity or practice that could create or increase certain systemic risks. Historically, FSOC has relied more heavily on its Section 113 authority to designate nonbank financial companies – however, after a recent judicial ruling vacating FSOC's designation of MetLife as systemically important, the 2019 Guidelines signal a shift of focus from Section 113 to the Section 120 activities-based authority. Currently, no nonbank financial companies are designated as systemically important.

The 2019 Guidelines differ from the 2012 Guidelines in certain key respects, including:

- **Activities-Based Approach.** Unlike the 2012 Guidelines, which focused exclusively on entity-specific determinations, under the 2019 Guidelines FSOC will prioritize its efforts to identify, assess and address potential risks and threats to U.S. financial stability through an activities-based approach. This approach is intended to identify and address, in consultation with relevant financial regulatory agencies, potential risks and emerging threats on a system-wide basis, regardless of charter, thereby reducing the potential for regulatory arbitrage and competitive

[1] The 2019 Guidelines become effective January 29, 2020.

[2] The original view of House Financial Services Committee Chairman Barney Frank was that the Dodd-Frank Act should focus on regulating activities regardless of charter, rather than legal entities. Chairman Frank's view is similar to the view recently expressed by ECB Chair Christine Lagarde—"same business, same risks, same rules." Introductory Statement, Hearing of the Committee on Economic and Monetary Affairs of the European Parliament (Dec. 2, 2019) (link).

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distortions that could arise from entity-specific determinations and allowing relevant regulatory agencies to address potential risks, rather than subjecting entities to new regulatory authorities.

- The 2019 Guidelines provide for FSOC first recommending new or heightened activity-based standards under its Section 120 authority before designating entities under Dodd-Frank Section 113.
- FSOC will focus on whether an activity could pose a potential risk to financial stability, such as asset valuation risk, credit risk, leverage, liquidity risk, maturity mismatch, counterparty risk and interconnectedness, growth of financial activities in unregulated sectors, operational risk, and the risk of destabilizing markets.
- FSOC will also consider whether an activity could amplify potential risks, focusing on (1) how a potential risk could be triggered, (2) how the adverse effects of a potential risk could be transmitted to financial markets or market participants, (3) the impact the potential risk could have on the financial system and (4) whether the adverse effects of the potential risk could impair the financial system in a manner that could harm the non-financial sector of the U.S. economy.
- If FSOC identifies a potential risk to U.S. financial stability, it would work with relevant federal- and state-level financial regulators to implement appropriate actions, such as modifying regulations or implementing new regulations, to address the risk—even going so far as to issue a public, nonbinding recommendation for new or heightened regulations.

- **Entity Designations as Last Resort.** The 2019 Guidelines retain the authority to designate individual nonbank financial entities as SIFIs but emphasize that entity designations are no longer FSOC's preferred approach. FSOC expects to consider nonbank designations "only if a potential risk or threat cannot be adequately addressed through an activities-based approach."
- **Changes to the SIFI Designation Process.** Responding to criticisms of the process laid out in the 2012 Guidelines, as well as the implicit rebuke in the MetLife judicial decision, the 2019 Guidelines make a number of key changes to the existing SIFI designation process, including:
  - requiring FSOC to determine, prior to any designation, that the expected benefits to financial stability from the entity-based designation justify the expected costs that the designation would impose;
  - reducing the number of stages of the designation process from three to two by eliminating what was Stage 1 in the 2012 Guidelines (under Stage 1, a set of uniform quantitative metrics was applied to a broad group of nonbank financial companies in order to identify firms that may be subject to further review);
  - requiring that FSOC assess the likelihood of a nonbank financial company's material financial distress when evaluating the entity for a potential designation, focusing on:
    - direct exposures other entities have to the company;
    - potential falls in asset prices if the company were forced to liquidate its assets quickly;
    - the liquidity of the company's liabilities; and
    - any critical function or service performed by the company that is relied upon by market participants and for which there are no ready substitutes;

  - increasing transparency of the designation process through engagement with entities under consideration, including providing entities with greater visibility into the aspects of their business that may pose risks to U.S. financial stability; and
  - creating procedures for an "off ramp" in which FSOC may rescind its SIFI designation if an entity or its regulators take steps to mitigate the potential risks identified in FSOC's written explanation of the basis for its designation.

  While FSOC retains discretion to consider factors other than those enumerated in the 2019 Guidelines, the Guidelines state that such a departure would require a reasoned explanation.

- **Cost-Benefit Analysis.** Pursuant to Dodd-Frank Section 120, FSOC may issue nonbinding recommendations to a primary financial regulatory agency to apply new or heightened standards and safeguards for a systemically risky financial activity or practice. The 2019 Guidelines provide that before making such a recommendation, FSOC will ascertain whether the primary financial regulatory agency would be expected to perform a cost-benefit analysis of the actions it would take in response to FSOC's contemplated recommendation. If no such analysis is expected, then FSOC will perform the cost-benefit analysis itself prior to making a final recommendation. When FSOC conducts its own analysis, it will make a recommendation under Section 120 only if it believes that the results of its assessment of benefits and costs support the recommendation.

The 2019 Guidelines evidence a clear commitment by FSOC to approach risks to the financial system in a more transparent and accountable manner. The 2019 Guidelines are designed to leverage the expertise of financial regulatory agencies to avoid unnecessary, duplicative, or inconsistent regulation. They are also designed to mitigate systemic risk while being sensitive to the regulatory arbitrage and competitive distortions that could arise from individual entity designations. The 2019 Guidelines evidence a strong commitment to cost-benefit analysis and greater rigor concerning analytics. The emphasis on the activities-based approach, as opposed to designating nonbank financial institutions as nonbank SIFIs, presumably will de-escalate, at least for a time, many of the objections and concerns with the designation process that resulted in protracted litigation over the past several years.

There are other important implications of the 2019 Guidelines that may not yet have garnered as much attention. By prioritizing an activities-based approach, the 2019 Guidelines more definitively position FSOC to focus on addressing new or existing activities that it views as posing undue risks to the financial system. In the coming years, no matter which political party is in power, FSOC will likely turn its attention more aggressively to identifying those products, activities or practices that it believes will pose undue risks to financial stability. As the 2019 Guidelines note, the issues that are of greatest concern to FSOC are often identified in FSOC Annual Reports. Some areas identified as potential emerging threats and vulnerabilities in the 2019 FSOC Annual Report include cybersecurity, central counterparties, short-term wholesale funding markets and investment funds.

Of particular interest in the 2019 FSOC Annual Report is the focus on financial innovation, including stable coins and payment systems, including through use of the blockchain. FSOC is likely to focus significant attention on these areas in the near future. FSOC had expressed concerns regarding the potential systemic risk implications to the financial system and the broader economy of widespread adoption of these products and activities. It notes that regulatory attention and coordination are critically important in light of the evolving market for digital assets and emphasizes that digital asset networks can be international and include a diverse set of nonfinancial, and thus unregulated, institutions, heightening the risk of illicit financial and national security risks. There are also concerns about operational risks with digital asset networks, which would be not only disruptive to users but also undermine confidence in the system as a whole. FSOC also notes that large technology and e-commerce companies providing financial services may increasingly compete with incumbent financial service providers, with the new entrants not being subject to financial services regulations that apply to the incumbents.

Equally as noteworthy as FSOC's activities-based focus on payment systems is the often forgotten authority of FSOC in Title VIII of Dodd-Frank to designate not only financial market utilities but certain payment, clearing or settlement **activities** as systemically important, thus providing authority for the Federal Reserve, the SEC or the CFTC to exercise rulemaking authority, as well as examination and enforcement authority, over the financial market utility or any "financial institution"[3] engaged in the activity, as applicable. Title VIII authorizes the Federal Reserve, the SEC and the CFTC to set standards for the conduct of systemically important payment, clearing and settlement activities of such financial institutions, as well as examine and issue enforcement actions against the financial institutions. Payment, clearing and settlement activities that are deemed systemically important could become subject to heightened regulatory standards. This broadly worded Title VIII authority has not yet been used to designate any activities as systemically important, but it has the potential to be a powerful complement to the authorities under the 2019 Guidelines.

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[3] Unlike FSOC's nonbank financial company designation authority, which is limited to companies that are "predominantly engaged in activities that are financial in nature or incidental thereto" – which the Federal Reserve has defined to require at least 85% of the company's revenues to be derived from financial activities – the Title VIII authority applies to any financial institution engaged in the designated payment, clearing and settlement activities, including certain specified financial institutions, such as banks, broker-dealers and investment companies, as well as *any* company engaged in activities that are financial in nature of incidental thereto. *See* 12 U.S.C. 5462(5)(A)(x). The scope of financial activities under both tests is quite broad.