Financial Services Regulatory Reform

2020 VISION EDITION

January 6, 2020

These slides are designed to be a reference tool for the financial regulatory reform landscape. They gather in one place the state of play on a number of topics and set forth our views on the general outlook. They will be updated from time to time. To stay up to date on all topics related to financial regulatory reform, we invite you to visit our one-stop website and blog at www.FinRegReform.com.

Table of Contents

Developments Percolating in All Three Branches of Government

Financial regulatory reform will be active during the first half of 2020 in Congress, the Courts and at the agencies. For the first half of 2020, the perspectives of the current administration and agency leadership will continue to be reflected at the agency level. We expect that Congress will become increasingly distracted by the elections and that, as ever, the courts will work on their own schedule, de-linked from the election cycle.

State of Play	
Legislative Environment	• After the passage of the bipartisan Economic Growth, Regulatory Relief, and Consumer Protection Act (**EGRRCPA**), concrete progress on further legislative initiatives has stalled, although the House Financial Services Committee, under the leadership of Chairwoman Waters, and the Senate Banking Committee, steered by Chairman Crapo, have been vocal about their policy priorities and oversight agendas. • Both committees have held an array of hearings, focusing on data privacy and security, payments systems, the need for and impact of fintech innovation in the financial services sector, GSE and housing finance reform, and the potential for legislative action on cannabis-related banking, with Chairman Crapo also devoting attention to capital formation and Chairwoman Waters emphasizing consumer protection and diversity. • We expect the sharply partisan backdrop of Congressional investigations and communications across a range of issues to escalate through the 2020 election. Although the committees' hearings schedule will continue to provide a forum for discussion of legislative priorities and policy debates, headway will likely only be seen in those increasingly limited areas with bipartisan support or where there is an appetite for extensive negotiation and compromise.
Regulators Forge Ahead	• The regulators have nearly concluded their legislative mandate to implement EGRRCPA, which had been a top priority for Republican legislators, while Democrats in Congress remain critical of the Trump Administration's "deregulatory agenda" for the financial sector. • Even absent additional legislation, the agencies have a full roster of regulatory reform priorities and new initiatives, including the finalization of Basel III, changes to the covered funds portion of the Volcker Rule, a regulatory proposal for the Community Reinvestment Act, changes to the brokered deposits rule and concerns about both encouraging and regulating innovation via fintech or digital currencies, all of which will continue to draw extensive scrutiny from both sides of the aisle.
Court in Session	• With Congress largely at an impasse, attention has shifted to the courts on a number of fronts. • The Supreme Court will hear arguments regarding the constitutionality of the CFPB's sole director structure this session, and a petition for certiorari in a suit arguing the constitutionality of the FHFA's sole director design is also pending. Meanwhile, the OCC's efforts to grant a special purpose fintech charter are mired in litigation brought by the New York State Department of Financial Services.

DRIVING THE CONVERSATION

Cannabis-Related Banking

- **General Outlook**
  - The direction of the federal regulatory and enforcement framework for financial institutions providing services to U.S. cannabis-related businesses has been unclear, and therefore virtually all banking organizations consider providing direct banking services to such businesses too perilous.
  - Two bills offering federal relief for cannabis-related banking services have been garnering bipartisan backing, and one recently passed in the House. It is unclear whether a legislative solution could pass in both chambers this year.
- **Cannabis Banking Bills**
  - The **Secure and Fair Enforcement Banking Act of 2019** (**SAFE Banking Act**) passed in the House on September 25, 2019, on a 321-103 vote, with 91 Republicans voting for the bill.
    - On December 18, Senate Banking Committee Chairman Crapo announced that he does not support the version of the bill which passed in the House, significantly decreasing the likelihood that the bill passes in the Senate.
    - Chairman Crapo is seeking a range of possible amendments, including THC concentration limits and measures to prevent illicit cash from entering state-regulated cannabis markets.
  - The **Strengthening the Tenth Amendment Through Entrusting States Act** (**STATES Act**) was most recently introduced in the House and the Senate in April 2019. The House bill has 63 co-sponsors, including 19 Republicans. The Senate bill has nine co-sponsors, including five Republicans.
  - Neither bill would legalize cannabis at the federal level or remove cannabis from Schedule 1 under the Controlled Substances Act (**CSA**)**.** The STATES Act, however, would amend the CSA to render inapplicable CSA prohibitions on cannabis-related conduct that complies with state or tribal law.
  - The SAFE Banking Act would permit "depository institutions" and insurers to provide financial services to cannabis-related businesses that comply with state laws regulating legal cannabis-related activity, or to hemp-related businesses complying with federal law. The STATES Act would permit "financial institutions" to do the same, but does not currently offer explicit protections for hemp-related businesses.
  - **Our visual memorandum analyzing these issues, updated on September 23, includes an in-depth discussion of both bills, as well as the Marijuana Opportunity Reinvestment Act, which would federally deschedule cannabis. The memorandum can be accessed here.**

Community Reinvestment Act

- **Change is Here?**
  - The FDIC and the OCC in December 2019 announced a proposed rule to modernize the CRA regulatory framework.
  - Key proposed changes to the CRA regulatory framework cover the following areas:
    - **CRA-Qualifying Activities**
    - **Assessment Areas**
    - **Evaluation Approach**
  - An overview of the proposal in each of these key areas is highlighted on the next slide.
- **Different Points of View:**
  - There is a broad, bipartisan consensus that CRA reform is needed, however:
    - The Federal Reserve did not join the FDIC and the OCC in the proposal.
    - Federal Reserve Governor Brainard prefers to moderately adjust the current regulatory framework, as opposed to following the transformational, metric-based approach.
    - A number of Democratic Senators and Representatives have expressed concern that the current reform effort may weaken the CRA.

Community Reinvestment Act

Expanding CRA-Qualifying Activities

- The proposed rule would expand the defined criteria that identifies the types of activities that can be considered qualifying activities. The expanded activities would include:
  - Retail loans provided to a low-or moderate-income (**LMI**) individual
  - Retail loans provided to a small business, or a small farm
  - Loans in Indian country
  - Small loans to a business or farm located in an LMI census tract
  - Community development activities that provide funding or services to an expansive range of projects and entities

Broadening Assessment Areas

- The proposed rule would add a new requirement for deposit-based assessment areas. This would mean that any analyzed area found to have a concentration of more than five percent of the institution's deposits would be considered a deposit-based assessment area.

Developing Metrics-Driven Evaluation Approach

- The proposed rule introduces the CRA Evaluation Measure, an overall quantitative measure of a bank's ongoing commitment to the CRA.

$$\left[\frac{\text{Qualifying Activities Value}}{\text{Average Quarterly Retail Domestic Deposits}}\right] + (.01)\left[\frac{\text{Branches in Specified Areas}}{\text{Total Branches}}\right]$$

GSE Reform

- **General Outlook:** Momentum is building toward meaningful administrative reforms as Federal Housing Finance Agency (**FHFA**) Director Calabria and other Administration officials pursue a determined agenda to overhaul the housing finance system and recapitalize and release the government-sponsored enterprises (**GSEs**) from conservatorship. Legislative reform may be more difficult to achieve.
- **Outlook for Reform**
  - **Trump Administration Plan:** The Treasury Secretary and the Housing and Urban Development (**HUD**) Secretary are pursuing plans released in September 2019 to reform the housing finance system.
  - **FHFA Strategic Plan:** Director Calabria is pursuing a strategic plan for the FHFA designed to prepare the GSEs for exiting conservatorship, which he has predicted could occur in 2022 or 2023. Elements of the plan include:
    - **Legislative:** (1) authorize the FHFA to charter new guarantors as competitors to the GSEs; (2) replace government support of the GSEs with an explicit guarantee by Ginnie Mae; and (3) give the FHFA more discretion to prescribe regulatory capital requirements for the GSEs
    - **Administrative:** (1) Treasury and FHFA should consider adjusting the "net worth sweep" of GSE earnings, allowing the GSEs to rebuild capital and positioning them to exit conservatorship; and (2) Treasury and FHFA should limit their support of GSE multifamily loans to statutory mandates on affordable housing and, to that end, may consider capping the multifamily footprint of each GSE.
  - **FHFA Capital Rule:** The FHFA intends to re-propose its capital regulations – with the goal of enabling the GSEs to rebuild the capital needed to exit conservatorship – "early" in the first quarter of 2020, according to Director Calabria in a December 10, 2019 speech.
  - **Democratic Opposition to Legislative Elements:** The Senate Banking Committee and House Financial Services Committee held hearings in September and October, 2019, respectively, on housing finance reform, during which Congressional Democrats expressed deep concerns that the plan would reduce access to homeownership. Senate Banking Committee Democrats echoed these concerns in a letter to Director Calabria and Secretary Mnuchin on December 17, 2019, pressing for more details on the timeline and scope of the GSE reform plans.

DRIVING THE CONVERSATION

Fed Faster Retail Payments

- **General Outlook:** The Federal Reserve announced on August 5, 2019 that it intends to build a new round-the-clock real-time payment and settlement service called the **FedNow Service** to support faster payments in the United States. The new 24x7x365 real-time gross settlement (**RTGS**) service for **retail payments**, which the Federal Reserve expects to be available in 2023 or 2024, may be accompanied by a separate expansion of hours for the Fedwire Funds Service and the National Settlement Service (**NSS**), which are designed for large-value wholesale payments. **Our client memorandum discussing the announcement is available here.**
- **The October 2018 Request for Comment and the August 2019 Announcement:**
  - In October 2018, the Federal Reserve released a request for comment on actions the Federal Reserve could take to support faster payments in the United States. It proposed two actions:
    - A Federal Reserve-developed RTGS service
    - A liquidity management tool that would enable transfers between Federal Reserve accounts on a 24x7x365 basis to support real-time interbank settlement of faster payments by the private sector or the Federal Reserve Banks
  - In August 2019, the Federal Reserve announced that it intended to proceed with the first of these two actions – the FedNow Service for real-time interbank settlement of payments – and released a request for comment on how the FedNow Service might be designed.
  - The Federal Reserve also determined that it should explore the expansion of hours for Fedwire Funds and NSS, so as to provide the liquidity management functionality described in the October 2018 request for comment, as well as additional benefits beyond the facilitation of faster payments.
    - Because of the "operational, risk, and policy considerations" that would be implicated by such a move, the Federal Reserve is not proceeding with an expansion of hours for Fedwire Funds and NSS at this time. Instead the Federal Reserve will analyze these considerations and, depending on the outcome of that analysis, may separately seek comment on the issue.

Fed Faster Retail Payments

- **Reactions:**
  - Responses to the August 2019 announcement are likely to expose the same fault lines as the October 2018 request for comment.
    - Larger financial institutions generally favor the Federal Reserve developing a liquidity management tool, but are against the Federal Reserve developing its own RTGS service for retail payments.
      - Concerns center around interoperability of the Federal Reserve's FedNow Service with the current RTP: Real-Time Payments System operated by The Clearing House, unnecessary competition between the Federal Reserve and the private sector, and duplicative costs.
        - These concerns appear to be shared, at least to some extent, by Federal Reserve Vice Chairman for Supervision Quarles. Vice Chairman Quarles voted against the August 2019 announcement and stated that he does not "see a strong justification for the Federal Reserve to move into this area and crowd out innovation when viable private-sector alternatives are available."
    - In contrast, community banks and credit unions strongly support the Federal Reserve developing an RTGS service for retail payments.
    - The community banks and credit unions have found allies in the form of fintechs and general retail corporates, such as Amazon, Walmart and Google, all of which favor the Federal Reserve's development of an RTGS service for retail payments.
      - In their comment letters last year, these firms voiced support for this service being extended to non-banks. In its August 2019 announcement, the Federal Reserve noted that the FedNow service, like existing Federal Reserve wholesale payment services, would be available only to "banks eligible to hold accounts at the Reserve Banks under applicable federal statutes and Federal Reserve rules, policies, and procedures."
    - The House and Senate held hearings on the Federal Reserve's proposal on September 25 and 26, 2019, with witnesses including the president of the Federal Reserve Bank of Kansas City. The hearings raised similar concerns as those discussed in these slides.

LIBOR Transition

- **General Outlook:** The London Interbank Offered Rate (**LIBOR**) will continue to be published through December 2021 but will probably not be found to be representative of an underlying market or economic reality by the primary regulator of the LIBOR administrator and will likely cease to be published beyond that date. As discussed in further detail in a July 15 speech by the Chief Executive of the U.K.'s Financial Conduct Authority, market participants and regulators are engaged in a significant effort to transition away from LIBOR to alternative rates by that time.
- Around the world, working groups representing the industry and regulators have been formed to manage the transition and identify LIBOR alternatives in particular jurisdictions.
  - In the United States, the Federal Reserve Board and New York Fed in 2014 created the Alternative Reference Rates Committee (**ARRC**), which consists of private market participants and official sector ex office members.
  - In 2017, the ARRC identified the Secured Overnight Financing Rate (**SOFR**) as its preferred U.S. LIBOR alternative.
- **Regulatory Space:**
  - Efforts are underway to promote regulatory certainty and, as needed, regulatory relief to encourage an early and voluntary transition from LIBOR to one or more other benchmark rates in advance of December 2021. Notable developments include:
    - On December 18, 2019, in response to an ARRC request, the CFTC provided no-action relief for certain swaps amended to transition away from LIBOR.
    - On November 7, 2019, the prudential regulators published a notice of proposed rulemaking that would provide relief for certain swaps amended to transition away from LIBOR. The comment period originally closed on December 9, 2019, but the proposal was reopened for comment through January 23, 2020.
- **Markets:**
  - Efforts are underway to encourage new non-LIBOR products—or to otherwise incorporate fallback language in anticipation of likely LIBOR cessation—as well as to amend existing contracts as necessary to account for likely LIBOR cessation.
    - Bodies including the ARRC and ISDA have published or are developing language and protocols to assist the industry in these transition efforts.

DRIVING THE CONVERSATION

Brokered Deposits

- **General Outlook:** The FDIC has issued an NPR to update its brokered deposit regulations. The proposal, although still constrained by statutory language that the Chairman of the FDIC would like to see changed, aims to update the regulatory framework to match the way banks take deposits in the digital era.
- The NPR seeks comments with respect to:
  - A new framework for analyzing whether deposits placed through deposit placement arrangements qualify as brokered deposits (including arrangements between IDIs and fintech companies)
  - Revisions to the “facilitation” prong of the deposit broker definition so that it applies to any person that engages in specified activities
  - Amendment of the “primary purpose” exception to apply when the primary purpose of an agent’s or nominee’s business relationship with its customers is not the placement of funds with IDIs
  - Clarification of the primary purpose exception for third parties that place deposits through brokerage sweep accounts, and to third parties whose primary purpose is enabling payments
    - The FDIC will establish an application process for any third party that wishes to use the primary purpose exception, and would require ongoing reporting.
- Chairman McWilliams stated that the FDIC’s primary objectives in producing the proposal include creating a more transparent and consistent process, minimizing risk to the Deposit Insurance Fund, ensuring consistency with the statute, and encouraging innovation in how banks offer services and products to customers.
- We expect to publish a memorandum discussing the NPR in greater detail promptly.

CFPB: Constitutional Challenges to Structure

- **General Outlook:** The Supreme Court granted certiorari to review a decision of the Ninth Circuit concerning the constitutionality of the CFPB's single director structure. An additional petition for certiorari concerning the CFPB's single director structure remains pending, along with a related petition concerning the FHFA's structure. Related appeals remain pending in the Second and Fifth Circuits.
- **Judicial Developments:**
  - On May 6, 2019, a three judge panel of the Ninth Circuit in *CFPB v. Seila Law LLC.* upheld the constitutionality of the CFPB's structure, drawing heavily on the reasoning of the earlier majority opinion of the D.C. Circuit, sitting *en banc*, in *PHH v. CFPB* and seeing "no need to re-plow the same ground."
  - On October 18, 2019, the Supreme Court granted certiorari with respect to the question of whether the CFPB's structure, as an independent agency with a single director removable only "for cause" represents an unconstitutional violation of the separation of powers doctrine. In granting certiorari, the Supreme Court directed the parties to brief and argue whether, if the CFPB is found unconstitutional on the basis of the separation of powers, the "for cause" removal provision of the CFPB's organic statute can be severed. Oral argument has been scheduled for March 3, 2020.
    - The government's brief recounted that the DOJ and CFPB have both concluded that the structure of the CFPB, including its single director removable only "for cause," is unconstitutional and that the appropriate remedy is for the "for cause" removal provision to be severed. Numerous amicus briefs have been filed arguing against severability if the structure is found to be unconstitutional.
    - On October 18, 2019, the Supreme Court granted leave for the House of Representatives to file an amicus brief in support of the Ninth Circuit decision upholding the CFPB's structure. In addition, the Supreme Court invited former Bush Administration Solicitor General Paul D. Clement to brief and argue the case, as amicus curiae, in support of the judgment below on the question whether the CFPB's structure with its single director removable only "for cause" is constitutional.

For more information on the *CFPB* litigation*, please visit the FinReg blog – "SDNY Weighs In on the Constitutionality of the CFPB's Structure" (June 22, 2018).*

Fintech Charters

- **General Outlook:** The fintech charter is likely to be caught up in litigation for several years.
- **Potential Methods of Change:**
  - **Charter**
    - In mid-2018, the OCC announced that it would begin accepting applications for special purpose **nondepository** national bank charters from fintech companies.
    - The release of the OCC's final policy statement and accompanying licensing manual supplement was quickly followed by criticism as well as litigation from the NYDFS and the Conference of State Bank Supervisors (**CSBS**), which had previously sued the OCC over its 2016 proposal to issue such charters.
    - The OCC has had mixed success in defending the fintech charter in court, creating short-term disincentives for prospective applicants and long-term uncertainty around the charter's future.
      - In October, the SDNY set aside the OCC's special purpose chartering authority with respect to nondepository fintech charters, finding that such a limited charter exceeds powers provided to the OCC under the National Bank Act and infringes on states' 10th amendment rights. The OCC appealed the decision on December 19.
      - The CSBS has attempted to assert similar arguments against the charter, but its claims have been dismissed twice due to standing and ripeness concerns.

For more information, please visit the *FinReg* blog – "*The Fintech Charter Goes into Hibernation*" (May 3, 2019).

Paypal v. CFPB

- **General Outlook:** On December 11, 2019, PayPal, Inc. filed suit against the CFPB in the D.C. District Court, alleging that the CFPB's 2016 Regulation E and Regulation Z rulemaking regarding prepaid accounts (**Prepaid Rule**) requires PayPal to make "misleading and confusing disclosures" about its product fees and functionalities." Furthermore, according to PayPal, the Prepaid Rule unreasonably restricts "consumers' abilities to link certain credit products to their PayPal accounts."
- **PayPal's Claims:** In the suit, PayPal argues that the CFPB's decision to subject digital wallets, such as those that are PayPal's primary consumer offering, to the same disclosure requirements as general purpose reloadable cards, despite PayPal's provision of extensive evidence distinguishing the two during the rulemaking process, is arbitrary and capricious. PayPal asserts that the Prepaid Rule "is fundamentally ill-suited to PayPal digital wallets and is likely to mislead or confuse consumers." According to PayPal:
  - The CFPB overstepped its statutory authority under the Electronic Funds Transfer Act when requiring mandatory, inflexible and "largely inaccurate" disclosures rather than optional disclosures.
  - The CFPB exceeded its statutory authority under the Truth in Lending Act by imposing a 30-day ban on customers' ability to link certain credit products to their digital wallets.
  - The CFPB's failure to adequately consider digital wallets' unique characteristics, and to adequately weigh the benefits of the Prepaid Rule against its burdens to digital wallets, violates the Administrative Procedures Act's "core requirement of reasoned decision-making."
  - The Prepaid Rule violates PayPal's First Amendment right to free speech by requiring PayPal to make specific disclosures, while preventing PayPal from including clarifying information in those disclosures.
- PayPal is seeking an injunction against the application of the Prepaid Rule to PayPal and for the rule to be set aside in whole or in part.

Rating Systems and Governance

- **General Outlook:**
  - The Federal Reserve's Large Financial Institution (**LFI**) Rating System will, in early 2020, be applied to a broader range of LFIs, meaning that by mid-2020 all BHCs with total consolidated assets of $100 billion or more, non-insurance and non-commercial SLHCs with total consolidated assets of $100 billion or more, and the U.S. IHCs of FBOs will have received ratings under the LFI Rating System.
  - Separately, the FDIC and Federal Reserve, though not the OCC, have sought feedback on the use of CAMELS ratings with respect to banks under their supervision.
- **LFI Rating System:** In connection with the LFI Rating System, the Federal Reserve continues to consider a proposed set of recalibrated supervisory expectations for boards of directors of U.S. BHCs and SLHCs (**Board Effectiveness Guidance**).
  - The Board Effectiveness Guidance, which was proposed in August 2017 and has not yet been finalized, was supposed to be used to inform the governance and controls component of the LFI Rating System. Until finalized, firms will be evaluated under existing supervisory guidance.
  - Guidance applicable to the boards of U.S. IHCs has not yet been proposed.
- There is also a proposal published in January 2018 on senior management, the management of business lines and IRM (**Management Guidance**). Like the Board Effectiveness Guidance, the Management Guidance was supposed to inform the governance and controls component of the LFI Rating System, but when and if this proposal will be finalized remains uncertain.
- **For a detailed discussion of the application of the pending proposals to LFIs, see our visual memorandum here.**
- **CAMELS Ratings:** In October 2019, the FDIC and Federal Reserve jointly issued a request for information soliciting comments on the consistency of assignment of CAMELS ratings and the use of CAMELS ratings in consideration of bank applications and enforcement actions.
  - The RFI explicitly noted that it was not a proposal to modify CAMELS ratings definitions, which are issued through the FFIEC, and the agencies' ultimate intentions with respect to CAMELS ratings are unclear, particularly given that the OCC did not join the RFI, and Comptroller Otting has been reported expressing skepticism on CAMELS reform.

For more information, please visit the *FinReg* blog – "*FDIC and Federal Reserve Request Comment on CAMELS Ratings*" (Oct. 21, 2019) and "*Visual Memoranda: The Federal Reserve's Proposed Governance Guidance for Boards and Management and Proposed Large Financial Institution Rating System*" (June 18, 2018).

Examinations

- **The banking regulators agree that examination and supervision needs to be more efficient, transparent and fair.**
  - Vice Chairman for Supervision Quarles has stated regulatory efficiency could "mean simpler examination procedures for bank supervisors, or less intrusive examinations for well managed firms."
  - FDIC Chairman McWilliams' "Trust Through Transparency" initiative aims to "transform the FDIC – in terms of technology, examination processes, and culture – to enhance the stability of the financial system, protect consumers, and reduce the compliance burden on regulated institutions."
    - The FDIC website advances these goals by publishing data on, for example, examination turnaround times and contested material supervisory determinations (**MSDs**).
  - CFPB Director Kraninger stated in July 2019 that the CFPB is reevaluating its examination process in order to "utilize technology to automate certain tasks" and take "full advantage of appropriate partnerships with fellow regulators."
- **In February 2018, the Federal Reserve proposed to streamline and expedite the process for appealing MSDs by:**
  - Reducing the levels of appeal from three to two and requiring that each appeals level be overseen by independent review panels
  - Establishing an accelerated appeals process for MSDs, such as loan reclassifications, that cause an institution to become critically undercapitalized
  - Including extensive provisions to protect banking organizations against retaliation by Federal Reserve staff for exercising the right to appeal, although uncertainty remains whether such provisions can ever be truly effective

For more information on the FDIC's "Trust Through Transparency" initiative, please visit the *FinReg* blog – "*A Breath of Fresh Air at the FDIC*" (Oct. 5, 2018). For more information on the Federal Reserve's proposal to expedite MSD appeals, please visit the *FinReg* blog – "*Legal Interpretations in Examination Appeals Should be More Transparent*" (Apr. 30, 2018).

Capital and Stress Testing

- **General Outlook:** U.S. banking agencies have unfinished business in implementing or finalizing U.S. Basel III capital requirements. Chairman Powell and Vice Chairman for Supervision Quarles have signaled that the intention is not to weaken capital, liquidity or stress-testing requirements, but to strengthen and improve them by making them more transparent, efficient and simple.

Upcoming and To-Be-Finalized Rulemakings

- Implementation of Stress Buffer Requirements (**SBR**) – proposed April 2018 (see slides 19 – 20)
- Other changes to Stress Testing and Capital Planning (**DFAST and CCAR**) – (see slide 22)
- Recalibration of enhanced SLR (**eSLR**) – proposed April 2018 (see slide 23)
- Vice Chairman for Supervision Quarles has stated that the Federal Reserve is "regularly" looking at the G-SIB surcharge "in the context of the overall body of regulation," including capital standards that have yet to be implemented (see slide 22)

Areas for Future Rulemakings

Capital Standards Finalized by Basel Committee but Not Yet Implemented in the United States	
• Fundamental Review of the Trading Book (**FRTB**) • Interest Rate Risk in Banking Book (**IRBB**) • Revised Securitization Framework • Revised Treatment of Investment Funds • Standardized Measure for Operational Risk	• Basel Committee released finalized revisions to the Basel III capital standards in December 2017 and revised requirements for market risk in January 2019 • Revised assessment methodology published for G-SIBs • Capital Floors for Credit Risk

For more information on the banking agencies' July 2019 final rule amending the U.S. Basel III capital rules to simplify the capital treatment of capital deductions and recognition of minority interests for non-advanced approaches banking organizations, see our client memorandum here.

Capital and Stress Testing

- **Stress Buffer Requirements:** If finalized, the Federal Reserve's April 2018 proposed rule on the implementation of the SBR would fundamentally change how stress testing is used to determine capital requirements for large BHCs.
    - The SBR proposal would eliminate the ability of the Federal Reserve to object to a capital plan on quantitative grounds, and instead incorporate stress losses directly into a firm's point-in-time capital requirements by replacing the 2.5% fixed portion of the capital conservation buffer with a new stress capital buffer (**SCB**) equal to a firm's peak-to-trough stress losses, on top of the G-SIB surcharge and any applicable countercyclical capital buffer.
    - The SBR proposal would incorporate four quarters of planned dividends based on a firm's baseline projections to the calibration of the SCB (the "**dividend pre-funding requirement"**).
    - The SBR proposal would also modify several assumptions in the CCAR framework to better align them with a firm's expected actions under stress, including a constant rather than growing balance sheet.
  - **Modifications Coming**
    - The Federal Reserve is still aiming to implement the SBR in time for the 2020 CCAR and DFAST cycle, according to Vice Chairman for Supervision Quarles's December 2019 testimony before the House Financial Services Committee.
        - Quarles highlighted maintaining the aggregate capital level as the most significant issue raised by the proposal.
    - In speeches in July and September 2019, Quarles stated that the SBR would be re-proposed "in the near future" in response to "extensive and thoughtful" comments.
        - Quarles stated that his goals for changes to the SBR are to increase simplicity, mitigate pro-cyclicality and maintain the overall level of loss absorbency in the system. Quarles also expressed concern about the volatility of stress test results and providing sufficient notice to firms of changes in their capital requirements.
    - In the September 2019 speech, Quarles stated his preference for eliminating two components of the 2018 SBR proposal:
        - Eliminating the stress leverage buffer so that risk-insensitive leverage requirements serve as a back-stop to risk-based requirements, as intended
        - Eliminating the dividend pre-funding requirement to simplify and eliminate redundancy in the SBR framework that could conflict with the mechanics of the SCB and existing provisions in the capital rules

For more information on SBR, please visit the *FinReg* blog – "*Federal Reserve Proposes Stress Capital Buffer Requirements in Overhaul of CCAR*" (Apr. 17, 2018); for further information on banking sector responses to the April 2018 proposal, see the comment letters submitted by the ABA, the IIB, and TCH, SIFMA, the FSR and ISDA (June 25, 2018).

Capital and Stress Testing

- Quarles' September 2019 speech also previewed two "co-equal options" that would make the overall capital buffer requirements less pro-cyclical:
  - The first alternative is to increase the countercyclical capital buffer (**CCyB**) to a non-zero baseline level during normal macroeconomic conditions, similar to the U.K. approach, while maintaining existing through-the-cycle capital levels that, at current levels, already adequately compensate for existing vulnerabilities
  - The second alternative is to increase the SCB floor from 2.5%, which would help reduce pro-cyclicality by limiting the reduction in SCB when stress losses decrease during good times and moderate increases in the SCB as conditions worsen
- In the July 2019 and earlier speeches, Quarles discussed other possible changes to the SBR framework that would address concerns about the volatility of the SCB and the sufficiency of notice to firms:
  - Averaging results of the stress test over multiple years, mitigating the volatility of the resulting SCB requirements
  - Modifying the timing of the requirement to submit final capital distribution plans relative to the release of the supervisory stress test results, including the annual recalibration of firms' SCB requirements
  - Modifying the market shock framework applicable to the six firms with the most significant trading activity to utilize more stress scenarios, rather than a single stress scenario

– **Multi-Step Approach:**

- Quarles had suggested in July and September 2019 that the Federal Reserve could implement the SBR via (1) a final rule with respect to certain elements of the SBR proposal and a re-proposal of other elements (which would be finalized at a later date) or (2) a re-proposal with a relatively brief comment period.
- If the Federal Reserve resolves to implement the SBR even in part by the 2020 CCAR and DFAST cycle, the former option would be the more likely one.

Capital and Stress Testing

- **CCyB:** In his September 2019 and earlier speeches, Vice Chairman for Supervision Quarles addressed possible changes to the CCyB
  - Quarles spoke approvingly of the U.K.'s implementation of the CCyB, calling it "a flexible mechanism that could complement other modifications to the SCB framework and allow the Board to adjust capital requirements as financial risks are evolving."
  - While the Federal Reserve has maintained the CCyB at zero since its introduction in 2016, the U.K. Financial Policy Committee has set the CCyB to one percent in normal conditions, offset by a one-time reduction of its other capital buffers. This framework provides U.K. authorities with the flexibility to either increase or decrease the CCyB from a one-percent baseline based on prevailing economic conditions, while maintaining overall capital requirements at appropriate levels under normal conditions.
  - In the September 2019 speech, Quarles implied that any increase in the "baseline" CCyB would be offset by changes to the SCB requirements, stating that his expectation is that "the new baseline for the CCyB would be set at a level that would maintain the overall level of capital in the U.S. banking system throughout the business and financial cycles."
    - Quarles clarified that, under this approach, there would be periods where the overall level of capital would be above or below the baseline, through-the-cycle levels of overall capital.
    - Quarles acknowledged that the advantage of this approach—i.e., enhancing the flexibility of the CCyB as a macroprudential tool "that could be adjusted quickly in response to economic, financial, or even geopolitical shocks"—would come at the cost of "additional layers of decisionmaking complexity" and would require the Federal Reserve to revisit its current CCyB policy.

Capital and Stress Testing

- **Stress Testing and Capital Planning (DFAST and CCAR):** There have been a number of changes to the stress testing and capital planning framework, including the following:
  - In March 2019, the Federal Reserve disclosed significantly more information on the models used to project bank losses for the stress tests than was disclosed in past years. The Federal Reserve is considering whether to publish its supervisory scenarios for comment.
  - In March 2019, the Federal Reserve issued a final rule that eliminates the CCAR qualitative objection for U.S. G-SIBs and all but five FBOs, and will phase out the CCAR qualitative objection for those five FBOs. In addition, the 2019 CCAR instructions excused all but 18 firms from the 2019 CCAR exercise.
  - The SBR proposal would also change certain CCAR and DFAST assumptions that could otherwise result in excessive stressed capital requirements for banking organizations that are subject to DFAST and CCAR.
  - EGRRCPA and the related tailoring rules also include changes to the DFAST stress testing requirements
  - **For a detailed discussion of the agencies' finalized tailoring rules with respect to U.S. banking organizations, see our visual memorandum here.**
- **G-SIB Surcharge Recalibration:** Vice Chairman for Supervision Quarles stated in his December 2019 testimony before the House Financial Services Committee that the Federal Reserve is "regularly" looking at recalibrating the G-SIB Surcharge "in the context of the overall body of regulation."
  - Quarles expressed caution about amending the capital regime in a piecemeal fashion only to find that the aggregate level of capital becomes set too high. In Chairman Powell's and Quarles' view, the aggregate level of loss absorbency should remain where it is.
  - Quarles further reiterated that the Federal Reserve has the "responsibility" to consider the G-SIB surcharge, the remaining implementation of Basel III, and other elements of the regulatory framework "as a package."

Capital and Stress Testing

- **Recalibration of Enhanced SLR:** If finalized, the Federal Reserve's and OCC's April 2018 proposed rule on the recalibration of eSLR would recalibrate and tailor leverage ratio requirements for U.S. G-SIBs by tying the eSLR buffer requirement to the risk-based G-SIB capital surcharge of each firm.
  - At the holding company level, the proposed rule would change the eSLR buffer from a fixed 2% to one half of each firm's G-SIB surcharge.
  - For the insured depository institution subsidiaries of G-SIBs that have the Federal Reserve or OCC as their primary federal regulator, the proposal would similarly change the current 6% "well capitalized" standard to 3% plus one half of the parent's G-SIB surcharge.
  - These changes correspond to changes to the Basel III rules proposed by the Basel Committee on Banking Supervision.
  - The proposal would also make corresponding changes to the calibration of the SLR components of the Total Loss Absorbing Capacity (**TLAC**) and long-term debt requirements for U.S. G-SIBs and invited comment on whether to recalibrate the TLAC SLR and long-term debt SLR to reflect more closely the capital refill framework and to more closely align the U.S. rules with international standards.
  - Vice Chairman for Supervision Quarles stated in his April 2018 testimony to the House Financial Services Committee that the objective of the eSLR calibration is to make sure that the eSLR is not a primary binding capital measure.
  - Quarles also stated that in that testimony that it would be appropriate to reconsider the proposed recalibration of the eSLR "to take account of the fact that certain [custody] banks would have had the denominator of the eSLR changed for them" under Section 402 of the EGRRCPA, which directs the U.S. banking agencies to exclude certain central bank deposits from the SLR denominator for certain custody banks. This section was recently implemented by final rule and will be effective from April 2020.

For more information on eSLR, please visit the *FinReg* blog – "*Federal Reserve and OCC Propose Tailoring of Enhanced Supplementary Leverage Ratios for GSIBs and their IDIs*" (Apr. 17, 2018).

Liquidity

- **General Outlook:**
  - **Net Stable Funding Ratio (NSFR):** According to the Fall 2019 Unified Regulatory Agenda, the agencies expect further action on the NSFR proposed rule, which was released in June 2016, in the first quarter of 2020.
    - Chairman Powell commented in a September 2019 press conference that the Federal Reserve is "looking at finalizing [the NSFR] in the relatively near future."
- **Effect of the Brokered Deposits NPR on the LCR:**
  - The NPR proposes a new framework for analyzing whether certain deposits qualify as brokered deposits, for which the LCR applies more stringent liquidity requirements based on higher assumptions for their outflow rates.
  - The NPR acknowledges that "[c]ertain calculations required under the [LCR] rule applicable to some large banks could also be affected by the proposed rule."
    - The NPR commented that the proposed rule's effects on the reported LCR could not yet be estimated, since there was not yet "a reliable estimate of the amount of deposits currently designated as brokered that would no longer be designated as such. . . ."
    - FDIC Director Gruenberg dissented from the NPR. He cautioned that recharacterizing certain brokered deposits as no longer brokered "could significantly lower the liquidity requirements for some of the largest, most systemically important banks." He suggested that the proposed rule's impact on the LCR could be "one of its most significant consequences" and warrants "much more careful consideration."
    - For more information, see the Brokered Deposits section at slide 10.

For a discussion on the Final Tailoring Rule's effects on LCR and NSFR requirements for U.S. banking organizations, see our visual memorandum here. For discussions on EGRRCPA's changes to the treatment of municipal securities under the LCR, see our visual memorandum here and visit the *FinReg* blog – "*Federal Banking Agencies Relax LCR Treatment of Municipal Bonds in Line with EGRRCPA*" (Aug. 23, 2018).

TLAC

- **General Outlook:** The Federal Reserve has expressed interest in streamlining parts of the TLAC requirements and some adjustments are likely.
- **Potential Methods of Change:**
  - In Vice Chairman for Supervision Quarles' January 2018 speech to the ABA Banking Law Committee, he stated that the Federal Reserve was considering simplifying its TLAC rule. Federal Reserve staff later stated that the Federal Reserve is going to take a "fresh look" at the TLAC rule.
  - Vice Chairman for Supervision Quarles' May 2018 remarks at Harvard proposed a "trust everyone, but brand your cattle" approach to internal TLAC, with host jurisdictions supporting SPOE resolution globally by moderating demand on global banks to pre-position internal TLAC and corresponding assets locally.
  - To this end, Vice Chairman for Supervision Quarles further stated in his May 2018 speech, as supplemented by a post-speech Q&A, that the Federal Reserve was considering, among other things:
    - Reducing its internal TLAC requirements applicable to the U.S. IHCs of foreign G-SIBs from 90% to 75% of external TLAC, perhaps on a reciprocal basis with host jurisdictions of the non-U.S. operations of U.S. G-SIBs
    - Eliminating its separate long-term debt requirement
  - The Treasury Banking Report recommends recalibrating internal TLAC requirements for U.S. IHCs by considering the foreign parent's ability to provide capital and liquidity resources to the U.S. IHC, provided arrangements are made with home country supervisors for deploying unallocated TLAC from the parent, among other factors.

For more information on TLAC, please visit the *FinReg* blog – "*Federal Reserve May Simplify the TLAC Rule*" (Jan. 30, 2018).

TLAC

- The Federal Reserve's and OCC's April 2018 proposal on the recalibration of eSLR would also make changes to the calibration of the SLR components of the TLAC and long-term debt requirements for U.S. G-SIBs, and invited comment on whether to recalibrate the TLAC SLR and long-term debt SLR to reflect more closely the capital refill framework and to more closely align the U.S. rules with international standards. The Fall 2019 Unified Regulatory Agenda describes the final rule adopting these changes as a "long-term action" and does not specify any expected timing for the final rule.
- The FDIC, Federal Reserve and OCC issued a joint proposal in April 2019 that would require advanced approaches banking organizations to deduct from their regulatory capital certain investments in unsecured debt instruments that were issued by G-SIBs for the purpose of meeting TLAC and long-term debt requirements or that are *pari passu* or subordinated to such instruments. The proposal would also require the U.S. G-SIBs and U.S IHCs of foreign G-SIBs that are subject to the TLAC rule to publicly disclose their long-term debt and TLAC. According to the Fall 2019 Unified Regulatory Agenda, the final rule is expected in February 2020.

For more information on TLAC, please visit the *FinReg* blog – "*Federal Reserve May Simplify the TLAC Rule*" (Jan. 30, 2018).

"Control" and "Controlling Influence"

- **General Outlook:** The existing definition of "control" under the Bank Holding Company Act (**BHC Act**) and Home Owners' Loan Act (**HOLA**), and particularly the Federal Reserve's interpretations of whether one company has a "controlling influence" over the management or policies of another company, have long created too much uncertainty in connection with investments in and by the banking sector.
  - Vice Chairman for Supervision Quarles has reiterated his position that further clarity is necessary in this area, explaining that divining whether the Federal Reserve will find control under the existing framework requires "supplication to a small handful of people who have spent a long apprenticeship in the subtle hermeneutics of Federal Reserve lore, receiving the wisdom of their elders through oral tradition in the way that gnostic secrets are transmitted from shaman to novice in the culture of some tribes of the Orinoco."
- On April 23, the Federal Reserve released proposed amendments to its regulations on "controlling influence." **See our client memorandum here for a detailed analysis of the proposal and our comment letter here for recommendations on why and how the amendments should go further to align the controlling influence test with a standard of actual control instead of mere potential ability to exercise a controlling influence.**
  - The rule is expected to be finalized in the first half of 2020.
  - Federal Reserve General Counsel Mark Van Der Weide has stated that the final rule will provide more clarity on legacy relationships and may move away from bright-line rules for some elements and instead use a case-by-case approach.

Chapter 14: Financial Institutions Bankruptcy Reform

- **General Outlook:** With a Democratic House majority, calls to repeal the Orderly Liquidation Authority (**OLA**) have subsided, and, if there is any legislative movement, the enactment of a new chapter 14 of the Bankruptcy Code (as an addition to OLA rather than a replacement) is more likely than a repeal of OLA.
  - The Financial Institutions Bankruptcy Act, which is based on the Hoover Institution's Chapter 14 proposal and would add a new Subchapter V (aka Chapter 14) to Chapter 11 of the Bankruptcy Code, passed the full House in 2016 and 2017.
  - Chapter 14 would facilitate SPOE resolution strategies for large financial companies by:
    - Facilitating the transfer of assets from a failed holding company to a bridge company to allow the continuing operation of operating subsidiaries outside of bankruptcy
    - Overriding cross-default rights in qualified financial contracts entered into by subsidiaries if certain conditions are satisfied, which is consistent with the ISDA Protocol and the QFC stay rules of the federal banking regulators
    - Providing a safe harbor from avoidance actions for transfers of assets to recapitalize the operating subsidiaries
  - In February 2018, the Treasury Department issued a long-awaited report in which it recommended the addition of a new chapter 14 to the Bankruptcy Code to facilitate the resolution of financial companies and thereby "narrow the path to OLA."
  - FDIC Chairman McWilliams endorsed efforts to adopt Chapter 14 legislation in a November 2018 speech.
  - Legislative movement is unlikely in an election year, but this issue may return after the elections or the time of a recessionary downturn.

For more information on the Treasury's OLA report, please visit the *FinReg* blog – "*Treasury: Retain but Reform OLA + Add New Chapter 14 to Bankruptcy Code*" (Feb. 22, 2018). For more information on the details of Chapter 14 of the Bankruptcy Code, please see the testimony of Davis Polk partner, Donald S. Bernstein, before the Subcommittee on Regulatory Reform, Commercial and Antitrust Law, and the book "*Making Failure Feasible: How Bankruptcy Reform Can End 'Too Big To Fail'*" by the Hoover Institution.

Living Wills

- **General Outlook:** With the October 2019 approval by the Federal Reserve and the FDIC of the final rule that amends and restates the 165(d) resolution planning rule (**165(d) Rule**), and the deadline for submission of 165(d) plans extended to either July 1, 2021 or July 1, 2022 (based on category of firm), attention shifts to the FDIC's IDI plan requirements (**IDI Rule**).
  - **See our visual memorandum here for our analysis of the 165(d) Rule.**
- **FDIC IDI Rule ANPR**
  - The FDIC issued an ANPR on the IDI Rule in April 2019 – no IDI plan submissions will be required until a revised IDI Rule is issued.
  - The ANPR considers and invites comment on topics including: (1) two alternative frameworks for tiered resolution planning requirements based on IDI size, complexity, funding structure, and other factors, (2) revisions to the content and frequency of submissions, and (3) changes to the pattern of engagement between the FDIC and IDIs on resolution-related matters.
    - The ANPR also invites comment on whether the FDIC should raise the $50 billion asset threshold, or if some other metric should be used, for determining which IDIs are subject to the IDI Rule.
    - Comments on the ANPR were due June 21, 2019. The FDIC has stated in the Fall Regulatory Agenda that it expects to release a notice of proposed rulemaking with respect to the IDI Rule in February 2020.
  - **Tiered Resolution Planning Frameworks and Content Requirements**
    - The ANPR proposes two alternative frameworks for tiered resolution planning requirements. Both frameworks would separate IDIs into three categories: the largest and most complex IDIs would fall into Tier A, large and complex regional banks would fall into Tier B, and smaller and less complex IDIs would fall into Tier C.
    - Under the first proposed framework, Tier A IDIs would be subject to all of the informational requirements of the amended (and more streamlined) IDI Rule. Tier B IDIs would be subject to even more streamlined informational requirements than Tier A firms. Tier C IDIs would not need to submit resolution plans.
    - Under the second proposed framework, the FDIC would tailor informational requirements for each tier A and Tier B firm, based on each firm's size, complexity, and other resolvability-related factors. Like the first framework, Tier C firms would not submit resolution plans.

Living Wills

- **Frequency of Submissions**
  - Under the first proposed framework, the FDIC is considering having Tier A firms file biennially, while Tier B firms file triennially. The FDIC also suggests that submissions could alternate between full and targeted submissions, similar to the 165(d) Rule.
  - Under the second proposed framework, Tier A and Tier B firms would submit resolution plans biennially or triennially, depending on the characteristics of the firm.
  - The ANPR also invites comment on the introduction of “Conditions-based supplemental resolution planning,” pursuant to which the FDIC, could subject IDIs, including Tier C firms, to immediate re-engagement and capabilities testing upon the IDI’s breach of a trigger demonstrating that the IDI’s financial condition has deteriorated.
- **Engagement and Capabilities Testing**
  - The ANPR invites comment on a revised pattern of engagement between the FDIC and all IDIs subject to the IDI Rule, in which the FDIC develops each IDI’s resolution strategy, and then engages directly with IDI staff to collect information or receive feedback on that strategy.
  - The ANPR also invites comment on how the FDIC could carry out and appropriately tailor regular capabilities testing for each IDI.

- **Guidance**
  - Proposed resolution plan guidance for FBOs may be released in the future.
  - Guidance on intra-group liquidity is expected in the future, although the timing on this proposed guidance is unclear.

For more information on this topic, please visit the *FinReg* blog – “FDIC Considers Amendments to Resolution Planning Requirements” (Apr. 17, 2019).

Volcker Rule – Funds

- **General Outlook:** The regulators finalized amendments to the proprietary trading and compliance portions of the Volcker Rule regulations in the second half of 2019. The covered funds portion of those regulations likely will be changed in 2020.
- **Finalized regulatory changes:**
  - The final amendments reflect a number of important changes to the proprietary trading and compliance provisions of the Volcker Rule regulations, including changes to the definition of trading account, the introduction of a new three-tiered compliance system, new definitional exclusions, new presumptions of compliance, elimination of Appendix B, modifications to Appendix A, and reduced and modified metrics requirements.
  - **Updated versions of our Volcker Rule flow charts that reflect this final rule are available here.**
  - Statutory amendments in EGRRCPA, enacting a community bank exemption have been addressed in separate rulemaking.
- **Covered Funds Provisions:**
  - The agencies are expected to propose additional amendments to the covered funds portion of the Volcker Rule regulations in early 2020.
  - At December hearings conducted by the Senate Banking Committee and the House Financial Services Committee, Republican Senators and Representatives urged swift action to refine the covered funds portion of the regulations.

For more information on Volcker Rule developments, please visit the *FinReg* blog – "*Davis Polk Client Memorandum: Agencies Extend Volcker Rule Relief for Qualifying Foreign Excluded Funds*" (Jul. 19, 2019) and "*Davis Polk Client Memorandum: Volcker Agencies Implement Small-Bank Exclusion and Name-Sharing Provisions of EGRRCPA*" (Jul. 17, 2019).

BSA/AML

- **General Outlook:** Regulatory change to the Bank Secrecy Act (**BSA**)/anti-money laundering (**AML**) regime remains a high priority.
  - We expect continued robust enforcement, and a focus on transparency, new financial technologies and platforms, and virtual currency.
  - There is also increased focus on ultimate beneficial ownership of entities. FinCEN Director Blanco noted in December 2019 remarks, discussed in more detail in our client memorandum, that:
    - More work need to be done to the Consumer Due Diligence Rule to close the "national security gap" in collecting beneficial ownership information for AML purposes.
    - The current rule does not require disclosure of "who really owns and controls a business and its assets at company formation."
- **Legislative Initiatives**
  - **The Coordinating Oversight, Upgrading and Innovating Technology, and Examiner Reform Act of 2019**
    - Focused on improving AML/countering the financing of terrorism oversight and modernizing the AML system
    - Placed on the House Calendar on October 21, 2019
  - **The Corporate Transparency Act of 2019**
    - Would amend the BSA to require that the beneficial owners of corporations or limited liability companies be disclosed to FinCEN at the time of formation and that such information be updated annually
    - Passed in the House on October 22, 2019
    - Currently with the Senate Committee on Banking, Housing and Urban Affairs

BSA/AML

- **The Financial Reporting Threshold Modernization Act**
  - Would increase the dollar thresholds for suspicious activity reports and currency transaction reports
  - Currently with the House Financial Services Committee
- **The Kleptocracy Asset Recovery Rewards Act**
  - Would establish within the Department of the Treasury the Kleptocracy Asset Recovery Rewards Program and authorize rewards to whistleblowers that provide information to the government about assets of corrupt foreign governments held at U.S. financial institutions
  - Currently with the Senate Committee on Banking, Housing, and Urban Affairs
- **The Illicit Cash Act**
  - Focused on modernizing FinCEN, improving AML/CFT oversight and adapting current and emerging technologies to combat money laundering and terrorist financing. Also requires that a company's beneficial owners be disclosed at the time of incorporation and that such information be updated
  - Currently with the Senate Committee on Banking, Housing, and Urban Affairs

Enforcement

- In recent years, FinCEN, banking supervisory agencies, including the NYDFS, as well as securities regulators, have brought substantial enforcement actions for BSA/AML violations.
  - The political and regulatory climate suggests that these efforts will continue.

For more information, please visit the *FinReg* blog – "*Bank Secrecy Act Reform Legislation Advanced Unanimously by House Financial Services Committee*" (May 17, 2019) and "*U.S. Regulators Announce BSA/AML Enforcement Actions Against U.S. Broker-Dealers*" (Jan. 2, 2019).

Derivatives

- **General Outlook:** Recent actions by the CFTC and SEC relating to swaps and security-based swaps evidence greater deference to international comity than any time since the passage of the Dodd-Frank Act.
- **CFTC Cross-Border Proposal:** The CFTC has proposed major changes to the cross-border application of its rules, including a proposal that would revise (1) which cross-border swaps must be counted when determining thresholds for registration as a swap dealer or major swap participant, (2) the cross-border application of certain substantive requirements to swap dealers and major swap participants and (3) the CFTC's framework for substituted compliance and comparability determinations.
- **SEC Rulemaking and Registration:** In December 2019, the SEC adopted rules related to the cross-border application of its security-based swap rules, including the treatment of security-based swaps that are "arranged, negotiated or executed" by personnel in the United States. These rules started the clock for registration of security-based swap dealers (**SBSDs**) and major security-based swap participants (**MSBSDs**). SBSDs and MSBSPs will be required to register and comply with the SEC's rules no earlier than September 1, 2021.
- **Recent Developments**
  - The SEC adopted rules related to risk mitigation techniques for uncleared security-based swaps.
  - The CFTC re-opened the comment period on its proposed capital requirements for swap dealers that are not prudentially regulated.
  - The federal banking agencies proposed rules for prudentially-regulated swap dealers and SBSDs that would no longer require these entities to hold initial margin for uncleared inter-affiliate swaps.
  - The CFTC issued no-action relief and the federal banking agencies proposed rules that would each allow certain legacy swaps to retain their legacy status if they are amended to replace discontinued rates, such as LIBOR.
  - The CFTC and the federal banking agencies have proposed to delay the implementation of the final initial margin requirements for entities with aggregate average notional amounts of uncleared derivatives between $8 billion and $50 billion until September 1, 2021.

Market Data Reforms

- **Overview**: Available market data on listed equity trading is currently split between "core" market data and "proprietary" market data sold directly by individual exchanges.
  - Exchanges are required to make core market data available through the SIP feeds, pursuant to a joint plan administered by the exchanges and FINRA, but many have raised concerns that the SIP feeds are too slow and do not contain sufficient information for modern trading.
  - Proprietary market data contains more information on available market liquidity, tends to be faster than the SIP feeds, but is more expensive.
- The SEC is considering proposing reforms to the "two-tiered" market data structure to increase the availability of more data at lower cost—including potentially:
  - Expanding what constitutes "core" data
  - Changing the SIP governance structure to increase transparency and address conflict of interest concerns
  - Introducing third-party competition to the SIP feeds
  - More aggressively reviewing proposed SIP and proprietary market data fee filings, in light of monopoly pricing concerns

For more information, please see the *FinReg* blog – "*Chairman Jay Clayton and Director Brett Redfearn Preview Potential Further Equity Market Structure Reforms – Exchange Market Data Business Model Targeted*" (March 18, 2019).

Marketplace Lending and the *Madden* Fix

- **General Outlook:** The FDIC and OCC have proposed regulations intended to address the uncertainty created by the 2nd Circuit's 2015 *Madden* decision, which called into question the enforceability of a loan's interest rate following the assignment of that loan to a non-bank.
- **OCC and FDIC Proposals:**
  - OCC: The OCC's proposal would amend its regulations applicable to national banks and savings associations to clarify that interest on a loan that is permissible when made by a national bank or savings association is not affected by a subsequent sale, assignment or other transfer of that loan.
    - The OCC views this as the "the natural result if one applies the valid-when-made principle," a longstanding Supreme Court precedent which the *Madden* court did not address or even acknowledge.
  - FDIC: Section 27 of the FDI Act provides state banks with interest rate authority similar to that provided to national banks. The FDIC is proposing to issue implementing regulations under section 27 for the first time. As proposed, those regulations would provide that the determination of whether interest on a loan is permissible under section 27 is to be made as of the date the loan is made, and is not to be affected by subsequent events, including changes in state law or a sale, assignment or transfer of the loan.
    - For its part, the FDIC states that its proposed interpretation is "not based on the common law 'valid when made' rule, although it is consistent with it."
- **Reactions and Further Developments:**
  - In November 2019, six Democratic Senators, including Senator Brown and Senator Warren, sent a letter to Comptroller Otting and Chairman McWilliams expressing their "strong opposition" to these proposals and calling the valid-when-made doctrine a "legal fiction."
  - In addition, in December 2019, Rep. Porter sent a letter to Chairman McWilliams, asking her to "ensur[e] that predatory lenders do not misinterpret the FDIC's proposal" as permitting them to use the "rent-a-bank model to evade California law."
  - If adopted as proposed, the ultimate fate of these regulations may rest with the courts, who may be called upon to determine whether the OCC and FDIC have permissibly interpreted the underlying statutes.
- **True Lender Issues:** Claims that the supposed true lender of a loan funded by a bank is in fact a nonbank partner of the bank also create potential uncertainty for marketplace lenders. The OCC and FDIC each note that their proposed regulations do not address this issue, with the FDIC adding that "it will view unfavorably entities that partner with a State bank with the sole goal of evading a lower interest rate established under the law of the entity's licensing State(s)."

For more on this topic, please refer to our white paper, *Federal Banking Regulators Can and Should Resolve* Madden *and True Lender Developments* (Aug. 14, 2018). and to the *FinReg* blog – "*U.S. Federal Banking Regulators Propose a* Madden *Fix*" (Nov. 21, 2019)

Central Bank Digital Currency

- **Overview**: Certain central banks, including the Federal Reserve, have been analyzing whether to issue digital currencies to supplement or replace traditional paper currencies in their jurisdictions. Although we do not foresee the Federal Reserve central banks launching a central bank digital currency (**CBDC**) in the foreseeable future, we expect that it and other central banks will continue to study this area and certain other central banks may issue a CBDC.
- **Background**: Many existing fintech products already enable users to digitally transfer traditional currencies out of existing accounts with commercial banks. CBDCs, by contrast, would be digitally-native assets enabling retail end-users, including households and businesses, to hold and spend central bank liabilities directly, without intermediation by commercial banks.
- Proponents of CBDCs identify a range of benefits compared to existing paper currencies:
  - Greater access to cash, because retail and other end-users would no longer be reliant on commercial banks for deposits and withdrawals
  - Creates a platform for innovation under the oversight of central banks and within existing financial regulatory regimes, whereas many existing fintech products operate in regulatory blind spots
- Critics argue that CBDCs could erode privacy and require major uplifts to central banks' monitoring and record-keeping systems. In CBDC systems, central banks would collect a running record of all payment data in their respective economies, which is a major departure from their roles in traditional cash systems.
- U.S. CBDC proposals are on a slow track according to reactions.
  - Secretary Mnuchin has stated that "in the near future—in the next five years—we see no need for the Fed to issue digital currency."
  - Fed Chair Jerome Powell has described central bank digital currency technology as in its "infancy."
  - Philadelphia Fed President Harker has stated that the U.S. "should [not] be the first mover as a nation to do this" but recognized that a shift to CBCDs is "inevitable."

Regulation Best Interest

- **Overview:** In June 2019, the SEC finalized rules and interpretations to enhance the standard of conduct of broker-dealers and investment advisers when they interact with retail investors (**Reg BI**).
  - The compliance date for Reg BI is June 30, 2020.
- **See our client memorandum here for a detailed analysis of the final rule.**
- Democratic lawmakers continue to criticize Reg BI as too lenient and Democratic Commissioners Jackson and Lee see opportunities to "strengthen" it through early interpretations and enforcement action.

Executive Compensation

- **General Outlook:** On March 5, 2019, The Wall Street Journal reported that U.S. federal banking regulators plan to revive efforts to regulate financial institution incentive compensation, as required under Section 956 of Dodd-Frank.
  - The relevant interagency rule, which was last re-proposed by six agencies in the spring of 2016, was never finalized and which seems unlikely to be approved.
  - On April 29, 2019, Comptroller Otting said his agency planned to move ahead with promulgation of the rule and that his goal is to propose a new version of the rule by the end of 2019.
  - Five of the six agencies (the SEC, OCC, FDIC, FHFA and NCUA) added the incentive compensation regulations to their respective unified agendas in the proposed rule stage. The OCC, FDIC and FHFA indicate a timetable that shows a notice of proposed rulemaking in December 2019, and for the NCUA, January 2020. The SEC indicates that this is a long-term agenda item and has no set timeline with respect to the proposed rule.
- In August 2018, Sen. Warren introduced the Accountable Capitalism Act, which would prohibit directors and officers of U.S. corporations from cashing out on equity compensation for five years after receiving such compensation, and for three years after a stock buyback, in order to disincentivize corporate use of equity compensation and stock buybacks to increase executive compensation. Prohibited cash-outs would incur a civil penalty. On February 13, 2019, Sen. Rubio echoed criticism of stock buyback programs, stating that he will file a bill taxing corporate buybacks the same way as dividends to eliminate the tax advantage of buybacks over dividends.
- On December 2018, the SEC adopted the hedging disclosure rule implementing Section 955 of Dodd-Frank. The rule requires public companies to describe any practices or policies regarding the ability of certain employees, officers or directors to purchase securities or other financial instruments or engage in transactions to hedge or offset a decrease in the market value of equity securities granted to or held by the employee, officer or director. For more information, please see our December 21, 2018 client memorandum here.
- In remarks in November 2018 and, again, in an address at a corporate governance conference on March 8, 2019, SEC Commissioner Jackson urged the SEC to finalize Dodd-Frank rules on clawbacks and pay versus performance.

For more information on developments in executive compensation, please visit the *FinReg* blog – "*Bank Pay Rules May Be Resurrected*" (March 12, 2019).