Financial Services Regulatory Reform

Fall Focus Edition

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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.

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Mix of Legislative and Regulatory Changes

Financial regulatory reform at both the statutory and regulatory level will continue to occur through a mix of changes in personnel, regulations, statutes, interpretations and guidance, with the courts engaged by stakeholders on all sides.

Legislative Change	
Bipartisan Banking Act	• The Economic Growth, Regulatory Relief, and Consumer Protection Act (**EGRRCPA** or **Bipartisan Banking Act**), with significant support from both sides of the aisle, was signed by President Trump on May 24, 2018. • The Bipartisan Banking Act impacts a number of areas of financial regulation, and those of its provisions requiring regulatory implementation will be high on the agencies' agendas.
JOBS 3.0	• On July 17, the House passed the JOBS and Investor Confidence Act of 2018 (**JOBS 3.0**) by a vote of 406-4. JOBS 3.0 focuses largely on capital markets reform provisions, but also includes other financial regulatory reform topics such as moving to a two-year living will submission cycle, exemptions from company-run stress testing for certain financial companies not primarily regulated by the federal banking agencies or the FHFA, and raising the limit on banks' investments in small business investment companies, subject to applicable agency approval. • Rep. Hensarling has stated that Senate Majority Leader McConnell has committed to a Senate vote on JOBS 3.0, and following its House passage, Sen. McConnell stated that "Senators will continue their ongoing bipartisan discussions as we work towards a vote in the coming months." The prospects for bipartisan support for JOBS 3.0 in the Senate are uncertain.
CHOICE Act	• Certain components of The Financial CHOICE Act of 2017 (**CHOICE Act**), which passed the House in 2017, have been passed separately in the House, and one—the Fair Access to Investment Research Act of 2017 (**FAIR Act**)—was passed by Congress in September 2017. Other provisions may yet be proposed as stand-alone bills in the House or as amendments to Senate bills as they are considered by the House.

Mix of Legislative and Regulatory Changes

Executive Order and Treasury Reports	
President Trump issued an Executive Order on Core Principles for Regulating the United States Financial System (**Core Principles**).	February 2017
The Treasury Department has published six reports on the conformity of U.S. financial regulations to the Core Principles, all of which are designed to influence financial regulatory reform:	
• *A Financial System that Creates Economic Opportunities: Banks and Credit Unions* (**Treasury Banking Report**)	June 2017
• *A Financial System that Creates Economic Opportunities: Capital Markets* (**Treasury Capital Markets Report**)	October 2017
• *A Financial System that Creates Economic Opportunities: Asset Management and Insurance* (**Treasury Asset Management Report**)	October 2017
• *Financial Stability Oversight Council Designations* (**Treasury FSOC Report**)	November 2017
• *Orderly Liquidation Authority and Bankruptcy Reform* (**Treasury OLA Report**)	February 2018
• *A Financial System that Creates Economic Opportunities: Nonbank Financials, Fintech, and Innovation* (**Treasury Fintech Report**)	July 2018

Changing the Regulatory Engagement Model

- **General Outlook:** New agency leadership is taking the opportunity to change how regulators engage with the banking sector. New leaders at multiple agencies are prioritizing regulatory reform in a variety of areas, addressing lessons learned about supervisory approach, new challenges posed by changing technologies and business models, and recommendations shaped by core principles set by the Trump administration.

  Federal Reserve

  - In a May 25 speech, Chairman Powell stated that "transparency and accountability around financial stability tools present particular challenges," but that the Federal Reserve would continue to "strive to find better ways to enhance transparency" and "strengthen the foundation of democratic legitimacy."
    - Chairman Powell noted also that the incorporation of public feedback has in many cases "produced more effective supervision and regulation" and that "[e]fforts to engage with the public—including consumer groups, academics, and the financial sector—are likely to lead to improved policies."
  - In April 17 testimony before the House Financial Services Committee, Vice Chairman for Supervision Quarles stated that "the regulation of [the financial] system should support and promote the system's efficiency just as it promotes its safety," and focused on a supervisory framework based on the three principles of efficiency, transparency and simplicity.
  - In August 2017 proposed guidance, the Federal Reserve stated that it was conducting a comprehensive review of all existing supervisory expectations and regulatory requirements relating to boards of directors in order that "unnecessary, redundant or outdated" expectations could be revised or eliminated.
    - The Federal Reserve stated that the first phase of its review had identified 27 supervisory letters for revision or elimination, and that the second phase of the review would focus on regulations and interagency guidance.
    - The proposed guidance was one of a series of Federal Reserve proposals, discussed below in the Rating Systems and Governance slides, aimed at clarifying supervisory expectations for and engagement with financial institutions' boards and senior management, among other matters.

For more information on improving the regulatory engagement model, please visit the FinReg blog – "As Regulatory Reform Push Continues, Federal Reserve Vice Chair for Supervision Randal Quarles Sets Out His Guiding Principles" (Jan. 23, 2018), and see our two visual memoranda – "Corporate Governance and Controls: The Federal Reserve's Governance and Management Proposals – Application to a Large U.S. Financial Institution" (June 5, 2018) and "The Federal Reserve's Proposed Large Financial Institution Rating System – Application to a Large U.S. Financial Institution" (June 5, 2018).

Changing the Regulatory Engagement Model

FDIC

- On June 19, in her first public remarks following her confirmation, FDIC Chairman McWilliams said she was approaching existing initiatives, including the Volcker Rule, with “fresh eyes”.
  - Chairman McWilliams commented that the regulators’ job is to “make sure the regulations we promulgate give them a clear path,” and stated that she wants to “see the exact nexus” between post-financial crisis rulemaking and how those rules will prevent future harm to the financial system.
- In an August interview, Chairman McWilliams identified a number of regulatory areas as ripe for review:
  - According to Chairman McWilliams, the FDIC, Fed and OCC should examine existing capital rules for bank all sizes under a rubric of “Is it doing what we intended for it to do?”
  - Chairman McWilliams also suggested that the regulators and banks should “work together” to test new products; assisting banks in introducing such products for underserved communities is one of her top priorities, together with “speeding up [the FDIC’s] review of bank-charter applications” and evaluation of small banks’ regulatory burden.

OCC

- In his June 2018 testimony before the Senate Banking Committee, Comptroller Otting emphasized the necessity of rationalizing the regulatory framework, including through reducing unnecessary regulatory burden and simplifying regulatory capital requirements.
  - Comptroller Otting highlighted effectiveness and efficiency in carrying out the OCC’s mission, and characterized the OCC’s supervisory approach as tailored to institutions’ risk and business models.
  - Otting went on to state his full commitment to quickly implementing the Bipartisan Banking Act’s provisions in cooperation with his fellow regulators, and to specific reforms discussed in the Community Reinvestment Act slides.

Changing the Regulatory Engagement Model

CFPB

- On January 17, Acting Director Mulvaney announced that the CFPB would "critically examine its policies and practices to ensure they align with the [CFPB's] statutory mandate," including by issuing a series of Requests for Information (**RFIs**) seeking public comment on the way the CFPB currently conducts its activities. The CFPB subsequently issued RFIs on:
  - Civil investigate demands; administrative adjudications; enforcement processes; supervisory processes; external engagements; consumer complaint reporting; rulemaking processes; rules adopted by the CFPB; rules inherited by the CFPB (i.e., those rules for which the Dodd-Frank Act transferred authority to the CFPB); guidance and implementation support; consumer financial education; and consumer inquiries

For more information on improving the regulatory engagement model, please visit the FinReg blog – "The CFPB and the Rule of Law" (Jan. 27, 2018) and "The CFPB's Call for Evidence: An Indication of Further Regulatory Rebalancing" (Jan. 19, 2018).

Structure and Authority: CFPB

- **General Outlook:** There are calls by the Trump Administration, Acting Director Mulvaney, and the private sector for a recalibration of the CFPB's power through both reorganization and circumscribed authority, with Democratic senators having a very different view. There is also a brewing circuit split on whether the CFPB's structure is constitutional.
- **CFPB 2018 Semi-Annual Report:**
  - The first semi-annual report issued under Acting Director Mulvaney includes a request that Congress make four changes to the law in order to establish meaningful CFPB accountability:
    - Fund the CFPB through Congressional appropriations
    - Require legislative approval of major CFPB rules
    - Ensure that the Director answers to the President in the exercise of executive authority
    - Create an independent CFPB Inspector General
  - Acting Director Mulvaney reiterated these four requests in his April 2018 testimony before Congress.
- **Judicial Developments:**
  - Appeals challenging the constitutionality of the CFPB's structure are pending in multiple circuits, including the Fifth Circuit. We believe a circuit split on the constitutionality of the CFPB's structure, followed by Supreme Court review, is increasingly likely.
  - On June 21, Senior United States District Judge Preska, presiding over *CFPB v. RD Legal Funding, LLC* in the Southern District of New York, found the CFPB's structure unconstitutional, in disagreement with the *en banc* ruling of the D.C. Circuit in a different case, *PHH v. CFPB*, in January 2018. In August, Judge Preska granted the CFPB's request for entry of final judgment against it, thus permitting the CFPB to appeal the ruling of the Second Circuit.

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).

Structure and Authority: CFPB

- The majority opinion of the D.C. Circuit, sitting *en banc*, in *PHH* had upheld the constitutionality of the CFPB's structure. Instead, Judge Preska adopted much of the dissent of Judge Kavanaugh, who President Trump has now nominated to the Supreme Court, in *PHH* to find that the structure of the CFPB as created by the Dodd-Frank Act—an agency headed by a single director, removable by the President only for "inefficiency, neglect of duty or malfeasance in office"—is unconstitutional.
  - In contrast to Judge Kavanaugh's dissent, Judge Preska found that the specific unconstitutional provision is not severable from the remainder of Title X of Dodd-Frank, and therefore determined that the entirety of Title X must be struck down. In his September confirmation hearings before the Senate Judiciary Committee, Judge Kavanaugh reiterated the remedy from his dissent: "I said the agency can keep operating … I specifically and explicitly rejected [throwing the Agency out] as a remedy."
- We also note the recent Fifth Circuit *per curiam* decision in *Collins v. Mnuchin*, in which plaintiffs claimed that the Federal Housing Finance Agency (**FHFA**) is "unconstitutionally structured because, among other things, it is headed by a single Director removable only for cause." In finding that the FHFA is indeed unconstitutionally structured, the Fifth Circuit stated that agencies "may be independent, but they may not be isolated," and that courts "must look at the aggregate effect of the insulating mechanisms."
  - Although the *Collins* court distinguished its ruling from *PHH*, it cited repeatedly to the *en banc* dissents of both Judges Kavanaugh and Henderson in *PHH.*
  - One of the pending challenges to the CFPB's structure is awaiting oral argument in the Fifth Circuit.

- **CFPB Leadership:** Richard Cordray resigned as CFPB Director on November 24, 2017 and President Trump appointed OMB Director Mulvaney as CFPB Acting Director under the authority granted to him by the Federal Vacancies Reform Act of 1998 **(FVRA**).
  - On June 18, 2018, President Trump nominated Kathleen Kraninger, currently Program Associate Director for General Government in the Office of Management and Budget, to be the permanent Director of the CFPB.
  - On August 23, the Senate Banking Committee approved Kraninger in a 13-12 party-line vote. Her confirmation now advances to the full Senate, which has yet to schedule a vote.

For more information on the FHFA litigation, please visit the FinReg blog – "Fifth Circuit Holds That FHFA is Unconstitutionally Structured" (July 18, 2018).

Structure and Authority: CFPB

- In her July 19 testimony before the Senate Banking Committee, Kraninger laid out her four priorities for the CFPB should she become Director:
  - To be fair and transparent, ensuring that CFPB actions empower consumers to make good choices and provide certainty for market participants, and particularly including the use of cost benefit analysis
  - To work closely with other financial regulators and states on supervision and enforcement to take aggressive action against bad actors
  - To ensure that data is protected and limit data collection to what is needed and required by law
  - To be accountable to the American people, including for the expenditure of resources
- Acting Director Mulvaney could remain at the CFPB through 2018 and into 2019.
  - Under the Federal Vacancies Reform Act of 1998 (**FVRA**), once the President nominates a permanent appointee, the acting appointee may continue to serve while the permanent appointee's nomination is pending. If the permanent appointee's nomination is rejected, withdrawn, or returned to the President, the acting appointee may serve for an additional 210 days from the point of such rejection, withdrawal or return, and additional extensions apply if and when a second nomination is made.

Structure and Authority: FSOC

- **General Outlook:** A divide between Congressional Republicans and the Treasury Department on appropriate FSOC authority seems resolved in favor of Treasury for now.
  - Many Republicans in Congress had called for significant FSOC organizational changes.
    - The House Financial Services Committee's February 28, 2017 report entitled "The Arbitrary and Inconsistent FSOC Nonbank Designation Process" argued that the FSOC does not follow its own rules and guidance for the nonbank designation process and that the FSOC's analysis of companies is inconsistent and arbitrary.
  - The Treasury FSOC Report and 2017 Annual Report, however, made it clear that the Treasury Department envisions both maintaining the current designation role for FSOC and expanding its coordination role.
  - In Treasury's view:
    - The FSOC should not limit its "broad discretion" in determining how to respond to potential threats to financial stability granted by the Dodd-Frank Act to only addressing risks at certain nonbank financial companies that may be designated.
    - The FSOC should prioritize activities-based, product-based or industry-wide risk identification, rather than singling out individual firms.
    - The FSOC's coordination role should reflect the newly identified risks of increased compliance costs and regulatory burdens for financial institutions as a potential threat to financial stability.
    - The FSOC should focus on activities-based regulation.

For more information on FSOC, please visit the FinReg blog – "FSOC 2017 Annual Report—A Subtle Shift in Tone that Signals the Possibility of Meaningful Change" (December 21, 2017) and "Treasury's Recommendation for FSOC: No CHOICE but to Play Double Duty" (November 20, 2017).

Structure and Authority: FSOC

- Congress signaled its acquiescence to Treasury's view when:
  - Provisions from the CHOICE Act that would have significantly curtailed FSOC's authority were not included in the Bipartisan Banking Act
  - In April 2018 when the House passed the FSOC Improvement Act, which would impose additional procedural requirements for nonbank SIFI designations but would not otherwise reduce FSOC's authority
- **Potential Changes Under Current Authority:**
  - The FSOC may make more aggressive use of its current statutory authority to serve as a forum with name-and-shame powers to coordinate a change in policy, encourage action at a member agency and facilitate member agencies entering into memoranda of understanding.
  - A Treasury official stated in September 2018 that the FSOC would be moving toward "an activities-based approach to designations" rather than a firm-focused approach.
- **Potential Changes Requiring Congressional Action:**
  - The Treasury Banking Report recommends that Congress expand the FSOC's authority to play a larger role in the coordination and direction of regulatory and supervisory policies, including by giving it the power to appoint a lead regulator on issues on which multiple agencies may have conflicting and overlapping regulatory jurisdiction and reforming the FSOC to further facilitate information sharing and coordination among regulators.

Cost-Benefit Analysis

- **General Outlook**: Several regulators appointed or nominated by President Trump have voiced general support for increased cost-benefit analysis and in some cases have already taken concrete steps to further that goal.
- **Federal Reserve**: The Federal Reserve has established a new office that, according to Chairman Powell, will "focus very particularly on cost-benefit analysis."
  - Vice Chairman for Supervision Quarles has asked his staff to conduct a comprehensive review of regulations related to capital, stress testing, liquidity and resolution in order to evaluate the costs and benefits of those regulations.
- **FDIC:** During her Senate confirmation hearings, FDIC Chairman McWilliams said that cost-benefit analysis is "crucial" and noted that, in her past work on consumer protection, without cost-benefit analysis it would not have been possible to know how consumers would be affected by various regulations.
- **CFTC**: CFTC Chairman Giancarlo's "SMART-REG" standard, first described during his time as a Commissioner and referenced again in more recent remarks, seeks to "measure success through a rigorous cost-benefit analysis."
- **SEC**: SEC Chairman Clayton has noted the SEC's commitment to performing "rigorous economic analyses of [its] rules" and has called those analyses "critical to identifying the benefits and costs of regulatory actions."
- **CFPB:** Kathleen Kraninger has stated that, if confirmed as permanent Director, she will ensure that the CFPB will "make robust use of cost benefit analysis."
  - Acting Director Mulvaney has established an Office of Cost-Benefit Analysis within the CFPB Director's office that, in addition to conducting a more rigorous, quantitative review of CFPB proposed rules than was the case in previous years, is also expected to review the potential effects of the CFPB's enforcement and supervisory actions.
- **Treasury Banking Report:** The Treasury Banking Report recommends that the independent financial regulatory agencies perform and make available a cost-benefit analysis for "economically significant" proposed regulations and strive to achieve greater consistency in their methodology and use of cost-benefit analysis.

Treatment of Supervisory/Regulatory Guidance

- **General Outlook:** In response to repeated questions from Congress and after a period of considerable uncertainty for financial institutions, the Federal Reserve, FDIC, OCC, NCUA and CFPB have released an interagency statement meant to clarify the role of supervisory guidance (**Interagency Guidance Statement**). Shortly thereafter, SEC Chairman Clayton released a statement of his own (**Clayton Statement**). These are welcome developments for supervised financial institutions, but how they will play out in practice remains to be seen.
- **Interagency Guidance Statement:**
  - The Interagency Guidance Statement affirms that, unlike a law or regulation, "supervisory guidance does not have the force and effect of law." As a result, "the agencies do not take enforcement actions based on supervisory guidance."
  - With these principles established, the Interagency Statement makes five commitments:

Interagency Guidance Statement Clarifying the Role of Supervisory Guidance – Key Commitments
▪ The agencies will limit the use of numerical thresholds or other "bright-lines" in describing expectations in supervisory guidance. Where numerical thresholds are used, those thresholds are exemplary only and not suggestive of requirements.
▪ Examiners will not criticize a supervised financial institution for a "violation" of supervisory guidance (the agencies put quotation marks around the word violation). Rather, any citations will be for violations of law, regulation, or non-compliance with enforcement orders or other enforceable conditions.
▪ Soliciting public comments on supervisory guidance is helpful to the agencies, and the agencies may continue to seek such comments, but soliciting comments does not mean that supervisory guidance is intended to have the force and effect of law.
▪ The agencies will seek to reduce the issuance of multiple supervisory guidance documents on the same topic.
▪ The agencies will continue efforts to make the role of supervisory guidance clear in their communications to examiners and to supervised financial institutions

Treatment of Supervisory/Regulatory Guidance

- **Clayton Statement**:
  - The Clayton Statement reiterates the SEC's "longstanding position" that all staff statements are nonbinding and "create no enforceable legal rights or obligations . . . it is the Commission and only the Commission that adopts rules and regulations that have the force and effect of law."
  - Directors of the Division of Enforcement and the Office of Compliance Inspections and Examinations have been instructed to "further emphasize" to their staffs the distinction between rules and regulations and staff views.
  - More generally, the SEC's divisions and offices have been and will continue to review whether prior staff statements and documents should modified, rescinded or supplemented "in light of market or other developments."
- **How We Arrived Here:**
  - For at least the past ten years, the failure to be in compliance with some guidance has often been treated as binding on banking organizations. It has often been used as the basis for matters requiring attention (**MRAs**) and matters requiring immediate attention (**MRIAs**) in examination reports and even for enforcement and other supervisory actions, sometimes with retroactive effect.
  - The muddled state of supervisory guidance practices was highlighted by two determinations made by the Government Accountability Office (**GAO**) late last year. First, in October 2017, the GAO determined that the 2013 Interagency Guidance on Leveraged Lending (**Leveraged Lending Guidance**) was a "rule" under the Congressional Review Act, and so could not become effective until it was submitted to Congress as required. A few months later, the GAO made the same determination with respect to the CFPB's indirect auto lending guidance.
  - Before the GAO made its determination as to the Leveraged Lending Guidance, it sought comment from the OCC's Chief Counsel and the General Counsels of the Federal Reserve and FDIC. Each insisted that the Leveraged Lending Guidance was not binding—this claim is difficult to credit, given public reports that the agencies had used the Leveraged Lending Guidance as the basis to issue MRIAs and MRAs.

Treatment of Supervisory/Regulatory Guidance

- **Congressional and Regulatory Responses:**
  - Because the Leveraged Lending Guidance and the indirect auto lending guidance were considered rules under the Congressional Review Act, the GAO's determinations gave rise to a time-limited window in which those rules could be repealed by Congress through use of fast-track procedures, including the ability to bypass a Senate filibuster.
  - Congress took no action to repeal the Leveraged Lending Guidance. Congress, however, did pass, and President Trump signed into law, a resolution of disapproval of the CFPB indirect auto lending guidance. This marked the first time that the Congressional Review Act was used to overturn regulatory guidance by a financial agency, as opposed to a formal rule.
  - At Congressional hearings in April, June and July respectively, Vice Chairman for Supervision Quarles, Comptroller Otting and Secretary Mnuchin stated that "guidance is guidance and rules are rules."
  - In the course of his July 12 appearance before the House Financial Services Committee, Secretary Mnuchin committed to Rep. Luetkemeyer that he would address the distinction between regulations and agency guidance at the next FSOC meeting.
  - FSOC meeting minutes from July 17 note that Secretary Mnuchin reiterated to the FSOC that "guidance plays an important role but that it is not intended to replace formal rulemaking."
- **Still to Come:**
  - For his part, Rep. Luetkemeyer welcomed the Interagency Guidance Statement, but called it only a first step in "restoring sanity and clarity in the regulatory regime."
  - Rep. Luetkemeyer intends to "introduce legislation to mandate that all guidance issued by federal regulatory agencies feature a disclosure stating the guidance has not gone through the formal rulemaking process and does not have the effect of law."

For more information on this topic, please visit the FinReg blog – "Interagency Statement on Supervisory Guidance Could Result in Meaningful Changes to Supervisory Practices" (Sept. 12, 2018).

"Control" and "Controlling Influence"

- **General Outlook**: The Federal Reserve plans to make "metamorphic" changes to how it determines whether one company has a "controlling influence" over the management or policies of another company for purposes of the Bank Holding Company Act (**BHC Act**), in an effort to make the process more transparent, simpler to understand, easier to apply and more consistent with the rule of law.
- **New Approach Required:**
  - The current definition of "control" under the BHC Act, and particularly the Federal Reserve's interpretations of what it means for a company to exercise a "controlling influence" over the management or policies of another company, have created too much uncertainty in connection with investments in and by the banking sector.
  - This uncertainty has led bank holding companies to limit their investments in fintech firms and restrain their business relationships with those firms for fear of being deemed to have "control" or a "controlling influence" over them.
  - In addition, the current control framework conflicts with the Federal Reserve's efforts to be more transparent. Many control precedents are not public and a number have been communicated only in discussions with Federal Reserve staff.
    - Noting that the Federal Reserve's definition of control in practice has been "quite a bit more ornate" than what is set out in the BHC Act, Vice Chairman for Supervision Quarles has joked that the only way one can become familiar with these interpretations is through an "apprenticeship in the art of Fed interpretation" with knowledge passed down through the generations as it is from a "shaman to a novice."
- **Momentum for Change:**
  - Vice Chairman for Supervision Quarles has stated publicly that the Federal Reserve will revise how it determines "control" or "controlling influence" under the BHC Act in order to make that process more transparent, simpler to understand, and easier to apply, including the codification of the determination framework and the liberalization of unspecified "existing limitations."
  - In June 2018 remarks, Federal Reserve General Counsel Van Der Weide suggested that a proposal regarding the control framework should be expected in the coming months.
  - The Treasury Fintech Report calls for the Federal Reserve, consistent with the above comments, to provide a "simpler and more transparent standard" in order to "facilitate innovation-related investments."

For more information on this topic, please visit the FinReg blog – "Treasury Calls on the Federal Reserve to Reassess the BHC Act Control Framework to Facilitate Innovation" (Aug. 6, 2018) and "Federal Reserve Signals Long-Overdue Re-examination of BHC Act Control Framework" (Jan. 24, 2018).

Rating Systems and Governance

- **General Outlook:** The Federal Reserve has issued a series of proposals that would recalibrate supervisory expectations for boards of directors, senior management, the management of business lines and independent risk management.
  - These recalibrated supervisory expectations would be used to evaluate a bank holding company's performance under the governance and controls component of a proposed new rating system for large financial institutions.
  - The proposals for supervisory expectations for boards of directors and senior management would be treated as guidance under the Interagency Guidance Statement, but the proposed new rating system for large financial institutions would be treated as a rule.
  - Separately, FDIC Chairman McWilliams has announced her intention to review the CAMELS rating system.
- **LFI Rating System:**
  - In August 2017, the Federal Reserve proposed a new Large Financial Institution rating system (**LFI Rating System**).
    - The proposed LFI Rating System includes component ratings for (1) capital planning and positions, (2) liquidity risk management and positions and (3) governance and controls.
      - As proposed, the governance and controls component would evaluate an LFI's (1) board of directors based on the proposed supervisory guidance for effective boards, discussed below, (2) management of business lines and independent risk management and controls, discussed below, and (3) recovery planning, for LISCC firms only.
    - The LFI Rating System would establish a four-category rating scale: Satisfactory, Satisfactory Watch, Deficient-1 and Deficient-2. An LFI must be rated Satisfactory or Satisfactory Watch for each component in order to be considered "well managed".
      - Unlike the current rating system, the proposed LFI rating system would not assign a composite rating.

For more information on the Federal Reserve's proposals, please see our two companion visual memoranda – "Corporate Governance and Controls The Federal Reserve's Governance and Management Proposals – Application to a Large U.S. Financial Institution" (June 5, 2018) and "The Federal Reserve's Proposed Large Financial Institution Rating System – Application to a Large U.S. Financial Institution" (June 5, 2018).

Rating Systems and Governance

- **Clarification of the Role of the Board:**
  - Also in August, 2017, the Federal Reserve issued proposed guidance intended to clarify its supervisory expectations for boards of directors, which had "become increasingly difficult to distinguish" from supervisory expectations for senior management (**Governance Proposal**).
    - Vice Chairman for Supervision Quarles later characterized the purpose of the Governance Proposal as an effort to "scale back some of the excessive micromanagement" of boards.
  - The Governance Proposal, the result of a multiyear Federal Reserve review, was divided into three parts:
    - Proposed supervisory guidance for effective boards of directors (**Board Effectiveness Guidance**)
    - Proposed rescissions or revisions of SR letters which provide guidance on the roles and responsibilities of holding company boards of directors, as discussed above in the Changing the Regulatory Engagement Model slides
    - Clarifications with respect to the communication of supervisory findings to provide that most MRIAs and MRAs should be directed to senior management, not boards of directors
  - The Federal Reserve's Governance Proposal is broadly consistent with the Treasury Banking Report, which recommends reassessing the regulatory requirements for a banking organization's board because current duties imposed on boards "lack appropriate tailoring and undermine the important distinction between the role of management and that of Boards."
    - The Treasury Banking Report also recommends an inter-agency review of the collective requirements imposed on boards to tailor aggregate expectations and strike a better balance between Board and senior management responsibilities.

Rating Systems and Governance

- **Management Guidance:**
  - In January 2018, the Federal Reserve proposed guidance that sets out core principles for effective senior management, management of business lines and independent risk management (**Management Guidance**).
  - The Management Guidance is intended to further the Federal Reserve's efforts to better distinguish between supervisory expectations for boards and supervisory expectations for senior management and would serve as the basis for evaluating an LFI's management of business lines and independent risk management and controls under the governance and controls component of the LFI Rating System.
- **Expected Developments:**
  - In general, comment letters submitted in response to the Federal Reserve's LFI Rating System, Governance Proposal and Management Guidance were supportive of the Federal Reserve's effort to take a principles-based approach to each proposal, though commenters did identify areas of the proposals that were overly prescriptive or in need of additional tailoring.
    - Commenters also noted the need for regulatory harmonization. For instance, it is not clear how elements of the OCC's Heightened Standards that are applicable to the boards of national banks would interact with the Federal Reserve's Board Effectiveness Guidance. This is a key issue for many LFIs because the boards of many large BHCs and their national bank subsidiaries often overlap.
  - While we expect the Federal Reserve to adopt the LFI Rating System, Governance Proposal and Management Guidance substantially as proposed, given the Bipartisan Banking Act's increased statutory threshold for many enhanced prudential standards (**EPS**) from $50 billion to $250 billion in total consolidated assets, it is likely that the applicability of the Federal Reserve's proposals will likewise be tailored to apply only to a smaller group of financial institutions.
  - **CAMELS Ratings:** The CAMELS rating system, adopted in 1979, has been criticized as "hopelessly out of date." In June 2018, newly appointed FDIC Chairman McWilliams stated that she wants the FDIC to be more transparent about its use of CAMELS ratings, and plans to seek public comment on ways to improve CAMELS ratings.

Examinations

- **Statutory Changes:**
  - The Bipartisan Banking Act raises the total consolidated asset threshold, under which eligible well-capitalized and well-managed community banks may qualify for an 18-month examination cycle, from $1 billion to $3 billion.
- **Regulatory Reform:**
  - The Federal Reserve, FDIC, OCC, NCUA and CFPB released the Interagency Guidance Statement in September 2018.
    - The agencies state that examiners will not criticize a supervised financial institution for a "violation" of supervisory guidance. Rather, any citations will be for violations of law, regulation, or non-compliance with enforcement orders or other enforceable conditions. Please see the Treatment of Supervisory/Regulatory Guidance slides for a more detailed discussion.
  - The Federal Reserve's February 2018 proposal to streamline and expedite the process for appealing material supervisory determinations (**MSDs**) would:
    - Reduce the levels of appeal from three to two, and require that each appeals level be overseen by independent review panels
    - Establish an accelerated appeals process for MSDs, such as loan reclassifications, that cause an institution to become critically undercapitalized
  - In a January 2018 speech, Vice Chairman for Supervision Quarles noted his focus on regulatory efficiency could "mean simpler examination procedures for bank supervisors, or less intrusive examinations for well managed firms."
  - In August 2018, the federal banking agencies issued interim final rules implementing the Bipartisan Banking Act's 18-month examination cycle for qualifying U.S. banks and U.S. branches and agencies of foreign banks with less than $3 billion in total assets.
  - Comptroller Otting's vision for a revised Community Reinvestment Act examination framework is discussed in the Community Reinvestment Act slides.

For more information on the Federal Reserve's proposed amendments to its guidelines on internal appeals of MSDs, please visit the FinReg blog – "Legal Interpretations in Examination Appeals Should be More Transparent" (April 30, 2018).

Examinations

- **Other Potential Methods of Change:**
  - The **Financial Institution Examination Responsiveness Act**, introduced in the House by Rep. Rothfus in November 2017, would allow institutions to appeal final material supervisory determinations to a three-judge independent examination review panel.
  - The **Treasury Banking Report**
    - States that regulators should improve the coordination of their examination activities and rationalize their examination and data collection procedures to promote accountability and clarity
    - Recommends improvements to the process for remediating regulatory issues
    - Recommends an inter-agency reassessment of the volume of MRA, MRIAs and consent orders
    - Recommends that regulators and banks develop an improved approach to clearing regulatory actions to reduce multiyear delays
  - The **Joint EGRPRA Report** to Congress acknowledges the burden arising from examinations, and the member agencies of the Federal Financial Institutions Examination Council (**FFIEC**) state that they plan to continue their efforts to review their examination processes.

Attorney-Client Privilege

- **Overview:** Banking sector attention is focused on challenging the federal banking agencies' position that they can bypass the long-established and crucial protections of attorney-client privilege.
- **The Banking Agencies' Position:**
  - The federal banking agencies have asserted that they have the authority to override attorney-client privilege and compel the production of otherwise protected information in both the (1) examination and supervision and (2) enforcement investigation contexts.
  - The agencies have taken this position in engagement with regulated entities, in agency guidance, in public statements and, for the CFPB, in a formal rule.
  - The agencies ground their position in their statutory examination and visitorial powers, as well as an asserted need to obtain privileged information to ensure safety and soundness.
  - The agencies further believe that 12 U.S.C. § 1828(x), which provides that submission of information to an agency does not constitute a waiver of privilege as to any third party, implicitly bolsters this position.
- **Contrast in Practice and Analysis:**
  - The banking agencies' position stands in contrast to the approach of the SEC and the DOJ, both of which have moved away from prior practices which had placed pressure on parties to agree to waivers in order to be considered cooperative. For over a decade, both SEC and DOJ policy have accepted that waiver of privilege is not a necessary element of cooperation, and recognized the importance of respecting and protecting attorney-client privilege.
  - As examined in detail in a recent memorandum produced by seven law firms in cooperation with a trade organization, available here, the banking agencies' position is contrary to long-standing judicial precedent, which has established that common law privileges cannot be overridden by statute unless Congress explicitly states such an intention, and the agencies' regulatory efficacy arguments are unsustainable and contrary to the policy imperatives underlying the attorney-client privilege.

For more analysis of the attorney-client privilege, please visit the FinReg blog – "Banking Regulators Examination Authority Does Not Override Attorney-Client Privilege" (May 16, 2018).

Enforcement

- **General Outlook:** Momentum for a change in approach at the agencies for the coordination of enforcement actions and penalties for essentially the same underlying conduct is real, but the outlook is hard to predict—the impact on companies may differ from the impact on individuals, and the impact on ongoing enforcement may differ from new enforcement.

  Banking Regulators

  - The Treasury Banking Report encourages the agencies to better coordinate enforcement activities and suggests that they consider coordinating enforcement actions such that only one regulator leads enforcement related to a single incident or set of facts.
  - On June 12, the Federal Reserve, OCC and FDIC issued a joint policy statement on enforcement to "promote notification of, and coordination on, formal enforcement actions," rescinding a 1997 FFIEC policy statement. The new policy statement recognizes the federal banking agencies' common interest in unsafe, unsound and other improper practices that may impact regulated institutions, and requires coordination of potential penalties in multiagency actions, consistent with the DOJ's efforts to avoid piling on multiple money penalties for essentially the same underlying conduct, as discussed on the next slide.

  CFPB

  - In January 2018, Acting Director Mulvaney issued a memo to staff rejecting "regulation by enforcement" and directing the agency to focus its enforcement efforts on "quantifiable and unavoidable harm" to consumers.
  - Also in January 2018, Acting Director Mulvaney issued a call for evidence, seeking public comment on the CFPB's enforcement, supervision, rulemaking and other activities.
  - On May 29, Acting Director Mulvaney announced in a speech that the CFPB, when determining if it should commence an enforcement action, would begin to consider whether the scale and rate of violations as compared to the overall size of a given market suggest that the violations are systematic or intentional.
  - The Treasury Banking Report's recommendations regarding the CFPB included requiring more clearly defined UDAAP interpretations and notice to regulated entities before monetary sanctions would be permitted.

For more information on these policy changes, please visit the FinReg blog – "Federal Banking Agencies' New Policy on Coordinating Enforcement Actions Is an Important First Step" (June 20, 2018), "The CFPB's Call for Evidence: An Indication of Further Regulatory Rebalancing" (January 19, 2018) and "The CFPB and the Rule of Law (January 27, 2018).

Enforcement

SEC

- Co-Director of the Division of Enforcement Avakian testified before the House Financial Services Committee in May 2018 that the success of an enforcement program should be measured by its focus "on the worst conduct, on the fraudulent conduct," rather than by "statistics like…how many actions…or the total amount of financial remedies ordered."
- SEC Commissioner Peirce has rejected the "broken windows" enforcement approach advocated by previous SEC Chair White, saying in a May 2018 speech, "The SEC must do its job, but we should save our enforcement program—with the great weight it carries—for violations of a sufficiently serious nature to warrant the expense to us and to those whom we pursue." Commissioner Peirce further stated that, "As tempting as it can be, it is wrong to try to do an end run around the APA by using the enforcement process to make policy."
- The SEC has pursued enforcement actions against Initial Coin Offerings (**ICOs**) that, in its view, violate federal securities laws. Chairman Clayton testified before Congress in February 2018 that it is an agency priority to "police these markets vigorously." Further, following a period of several months in 2018 when some have questioned the SEC's focus on crypto enforcement, the early weeks of September 2018 saw a spate of enforcement activity involving crypto assets.
- On June 21, the Supreme Court held in *Lucia v. SEC* that the SEC's administrative law judges (**ALJs**) are "officers" under the Constitution, and therefore the pre-November 2017 appointment of ALJs by SEC staff rather than by the Commission itself had been unconstitutional under the Appointments Clause of the Constitution. The decision is likely to have far-reaching consequences across federal agencies using ALJs.
  - In a July 10 Executive Order, President Trump placed the ALJ position in the excepted service category, which does not impose the same hiring requirements as the competitive service category, stating that this change will, among other things, "provide agency heads with additional flexibility to assess potential appointees" and "mitigate concerns about undue limitations on the selection of ALJs."
  - The SEC, which had previously stayed pending administrative proceedings following the *Lucia* decision, issued an order on August 22 providing all respondents in pending proceedings with the opportunity for a new hearing.

For more information on the SEC's crypto enforcement actions, please visit the FinReg blog – "Regulators Step Up Enforcement on Crypto Firms" (Sept. 13, 2018). For more information on the potential consequences of Lucia v. SEC*, please see Davis Polk client memorandum – "Securities Litigation Update: After Full D.C. Circuit Deadlocks, Circuit Court Split Over Constitutionality of SEC Administrative Law Judges Likely Bound for Supreme Court" (June 28, 2017).*

Enforcement

CFTC

- Chairman Giancarlo has noted that the agency will continue to aggressively pursue enforcement, but also emphasized that it should do so in cooperation with other federal and state regulators and enforcement agencies.
- The CFTC has pursued enforcement actions against alleged fraud, market manipulation and disruptive trading involving virtual currencies, and Chairman Giancarlo testified before Congress in February 2018 that the agency will coordinate with the SEC and other agencies to “aggressively prosecute bad actors” engaging in such activities.

DOJ

- In May 2018, Deputy Attorney General Rosenstein announced a new policy to discourage multiple regulators from piling on penalties, instructing DOJ lawyers to coordinate with each other and with other enforcement agencies when imposing multiple penalties on a company for the same conduct.
- In January 2018, Associate Attorney General Bran announced a new policy that will prohibit the DOJ from using guidance documents—or noncompliance with guidance documents—to establish violations of law in civil enforcement actions.

State and foreign regulators and prosecutors remain on the scene:

- For example, Superintendent Vullo of the New York Department of Financial Services (**NYDFS**) stated in January 2018 that the NYDFS will seek to fill any enforcement void left by deregulation at the federal level.

For more information on Chairman Giancarlo’s vision for the CFTC, including with respect to enforcement, please visit the FinReg blog – “The Giancarlo Agenda: The CFTC Gets Back to Basics” (March 17, 2017) and “CFTC Acts Against Bitcoin Fraud: Enforcement Against Garden Variety Fraud with Implications for Virtual Currencies and ICOs” (September 22, 2017).

International Cooperation

- **General Outlook:** U.S. involvement in international standard-setting bodies continues to generate debate, with strong views on both sides. There is more support for cross-border engagement on resolution planning than in other areas.
  - In a June 2018 speech, Vice Chairman for Supervision Quarles strongly defended international efforts to promote financial stability as "often the best way to tackle problems that are global in scope."
    - Quarles advocated active U.S. participation in the Financial Stability Board (**FSB**), which he views as in our national interest given the benefits gained by community banks, consumers and businesses from a stronger financial system and the adoption of consistent standards across major economies.
    - Quarles is said to be a leading candidate to be the next chairman of the FSB, although his chances have fallen since President Trump announced his aggressive tariff and other international trade actions and policies.
  - A Core Principle in President Trump's February 3, 2017 Executive Order is the advancement of American interests in international financial negotiations and meetings.
  - Former Chair Yellen affirmed the agencies' continued participation in the development of international regulatory standards, and Chairman Powell has maintained this position.
  - In January 2018, a group of Republican senators sent President Trump a public letter criticizing the level of FSB influence on U.S. policy making, urging less deference to global standards and greater focus instead on the interests of U.S. entities and U.S. consumers.
  - FDIC Chairman McWilliams has expressed skepticism toward international cooperation. In remarks two weeks after her confirmation, she stated that she views international bodies such as the Basel Committee "with some suspicion" and that U.S. regulators should be willing to depart from international standards.

International Cooperation

- In a September 2018 speech in London, CFTC Chairman Giancarlo expressed strong support for multilateralism and accepted fault for the CFTC's over-expansive assertion of jurisdiction in the past, proposing "an updated and improved" vision for cross-border swaps regulation and promising a forthcoming white paper.
  - Among other measures, he advocated a more flexible approach to substituted compliance, which would allow market participants to comply with non-U.S. regulations in lieu of CFTC regulations based on a comparability determination of the non-U.S regime as a whole rather than on a rule-by-rule basis.
  - In addition, the white paper will recommend relaxing requirements for non-U.S. central counterparties (**CCPs**) that do not pose substantial risk to the U.S. financial system and are subject to comparable home-country regulation.
- In August 2018, the U.K. Financial Conduct Authority led a group of 12 regulators, including the CFPB, in proposing the Global Financial Innovation Network (**GFIN**) to promote cross-border collaboration towards the development of a "global sandbox" for fintech firms.
  - The GFIN's functions would include information sharing, joint policy work and regulatory trials among regulators, and supporting companies in conducting trials across multiple jurisdictions.

International Cooperation

- **Statutory Developments:**
  - Section 211 of the Bipartisan Banking Act seeks to promote greater transparency and accountability regarding U.S. regulators' participation in international insurance regulatory and standard-setting bodies, e.g., by requiring annual reports to relevant Congressional committees from the Federal Reserve Chair and Treasury Secretary.
  - JOBS 3.0 would significantly curtail U.S. participation in the development of international insurance regulatory standards. For example, it would prohibit U.S. representatives from agreeing to international proposals "if the proposed agreement or standard fails to recognize the United States system of insurance regulation as satisfying such proposals."
- **Other Potential Methods of Change:**
  - The Treasury Banking Report recommends that the U.S. lead efforts to:
    - Streamline the mandates of international standard-setting bodies' initiatives
    - Eliminate existing overlapping objectives
    - Increase transparency and accountability in these bodies
    - Advocate for and shape international regulatory standards that are in alignment with domestic financial regulatory objectives
  - The Treasury OLA Report urges strong cooperation with non-U.S. resolution authorities, not only to support preparedness but also to reduce foreign regulators' incentive to take harmful self-protective measures such as ex post ring fencing or ex ante requirements to pre-position more capital and liquidity in host jurisdictions.
  - The Treasury Fintech Report, while sounding a note of caution against the premature adoption of international standards in the quickly-evolving fintech space, endorses proactive U.S. engagement with international counterparts to avoid regulatory fragmentation, facilitate cross-border investment and benefit from lessons learned regarding different regulatory approaches.

Tailored Regulation by Size and Business Model

- **General Outlook**: The Bipartisan Banking Act codifies the strong consensus that regulation and supervision should be tailored to a banking organization's business model and risk profile by raising many existing asset size thresholds. We believe its passage meaningfully reduces the odds that this Congress will pass other bills designed to further tailor regulation.
  - Most notably, the Act raises the statutory thresholds, generally from $50 billion to $250 billion in total consolidated assets, for many of the Federal Reserve's EPS, including:
    - Resolution planning
    - DFAST stress testing:
      - Supervisory DFAST threshold raised from $50 billion to $100 billion in total consolidated assets
      - Company-run DFAST threshold raised from $10 billion to $250 billion in total consolidated assets
    - Liquidity stress testing and buffer requirements
    - Single-counterparty credit limits (**SCCL**)
      - The Federal Reserve's recently issued final SCCL rule applies the new EPS thresholds under the Bipartisan Banking Act.
    - The Act allows the Federal Reserve to raise or lower this threshold in certain circumstances.
  - On July 6, the Federal Reserve, OCC and FDIC issued an interagency statement and the Federal Reserve issued its own supplementary statement regarding the interim positions these agencies will take with respect to the impact of the Act on firms of various asset sizes until the relevant agencies can amend their regulations to incorporate changes made by the Act.
  - For more detail on the targeted relief to capital and liquidity regulations provided by the Bipartisan Banking Act, see the Capital and Stress Testing and Liquidity slides.
  - See our visual memorandum here describing the key changes the Act makes to the regulation of banking organizations—color coded for those who want to look only at the changes that affect their own organization.

Tailored Regulation by Size and Business Model

- **Federal Agencies Have Also Been Tailoring Their Regulations:**
  - In March 2017, the Federal Reserve raised the asset thresholds indicating presumptive financial stability concerns in banking M&A transactions.
  - The U.S. banking agencies have also proposed and finalized rules to further tailor their capital and stress testing rules to banking organizations' size and operations, as described in more detail in the Capital and Stress Testing slides.
  - See the Foreign Banking Organizations slides for a discussion of tailoring applicable to those entities.
  - In a July 18 speech to the ABA, Vice Chairman for Supervision Quarles highlighted tools and factors the Federal Reserve could use to further tailor its regulations going forward, noting that the cross-border activity and short-term wholesale funding factors from the G-SIB surcharge framework and measures of nonbank activities that are embedded in existing regulations may be helpful tools in tailoring regulations to firms' risks.
    - Quarles also argued for further tailoring regulations for less complex and less interconnected firms with $250 billion or more in total consolidated assets, which are not eligible for statutory relief under the Bipartisan Banking Act.

Tailored Regulation by Size and Business Model

- The following chart summarizes the current state of play of asset-based regulatory thresholds applicable to U.S. BHCs under the U.S. banking agencies' interim positions with respect to the Bipartisan Banking Act:

	< $10B	≥ $10B, < $50B	≥ $50B, < $100B	≥ $100B, < $250B	≥ $250B	G-SIBs
Recovery Plans						✓
TLAC Requirement						✓
G-SIB Surcharge						✓
Enhanced Supplementary Leverage Ratio						✓
Supplementary Leverage Ratio					✓	✓
AOCI Included in Basel 3 capital					✓	✓
Full Liquidity Coverage Ratio					✓	✓
Advanced Approach Risk Weighted Assets					✓	✓
Single-Counterparty Credit Limits (SCCL)[1]					✓	✓
Section 165(d) Resolution Plans[2]				✓	✓	✓
Company-Run DFAST[2]				✓	✓	✓
Supervisory DFAST				✓	✓	✓
CCAR				✓	✓	✓
Modified Liquidity Coverage Ratio				✓	✓	✓
FDIC IDI Plans			✓	✓	✓	✓
Early Remediation Tools			✓	✓	✓	✓
Risk Management Committee (*for publicly traded BHCs*)			✓	✓	✓	✓
Durbin Amendment (Interchange Fee Restrictions)		✓	✓	✓	✓	✓
Subject to Regulation by CFPB	**Certain Products**	✓	✓	✓	✓	✓
Volcker Rule	**Eligible for Exemption**	✓	✓	✓	✓	✓
Prompt Corrective Action Tools	✓	✓	✓	✓	✓	✓

1. As finalized, the SCCL rule does not apply to BHCs with $100 billion or more but less than $250 billion in total consolidated assets, although the preamble noted that the Federal Reserve could choose to apply the rule to some or all of these firms at a later date.

2. The Federal Reserve may choose to exempt some or all BHCs with $100 billion or more but less than $250 billion in total consolidated assets.

Capital and Stress Testing

- **General Outlook:** U.S. banking agencies have unfinished business in implementing or finalizing U.S. Basel III capital and liquidity requirements, but Vice Chairman for Supervision Quarles has signaled that the intention is not to weaken capital, liquidity or stress-testing requirements, but to make them more transparent, efficient and simple.
  - **Capital**
    - Simplification of Capital Rules for Non-Advanced Approaches Firms – proposed September 2017 (see slides 33-34)
    - Implementation of Stress Buffer Requirements (**SBR**) – proposed April 2018 (see slide 37)
    - Recalibration of enhanced SLR (**eSLR**) – proposed April 2018 (see slide 38)
    - Capital treatment of Current Expected Credit Losses methodology (**CECL**) – proposed 2018
    - House Republicans sent a July 27 letter to Vice Chairman for Supervision Quarles urging him to recalibrate the G-SIB surcharge, especially in light of U.S. goldplating relative to international standards, duplication with other post-crisis reforms and the failure of the existing calibration to take into account general improvements in resolvability
  - **Stress Testing and Capital Planning (DFAST and CCAR)**
    - Federal Reserve released a set of proposals in December 2017 aimed at increasing transparency of its stress testing (**DFAST**) and capital planning (**CCAR**) programs, which would release greater information about the models it uses to estimate hypothetical losses for purposes of DFAST and CCAR
    - 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 the DFAST and CCAR programs

For more information on the revised G-SIB assessment methodology, visit the FinReg blog – "Basel Committee Publishes Revised Assessment Methodology for GSIBs" (July 6, 2018).

Capital and Stress Testing

- **Simplification of Capital Rules for Non-Advanced Approaches Firms**: In September 2017, the U.S. banking agencies proposed simplifying certain aspects of their Basel III capital rules and making some technical corrections to them. The simplification proposals would affect non-advanced approaches banking organizations and would result in the following changes:
  - **Simplified Treatment of Threshold Deduction Items:** For mortgage servicing assets (MSAs), temporary difference deferred tax assets (DTAs), and significant investments in unconsolidated financial institutions, the proposal would:
    - Replace the 10% of CET 1 capital deduction thresholds for each category with 25% of CET 1 capital thresholds
    - Eliminate the distinction between significant and non-significant investments in unconsolidated financial institutions and treat all investments in unconsolidated financial institutions as subject to a single 25% of CET 1 capital threshold
    - Eliminate the aggregate 15% of CET 1 threshold for the combined impact of the three categories of deduction items
    - Risk weight MSAs and temporary difference DTAs that are not deducted from CET 1 capital at 250%
    - Risk weight investments in the capital of unconsolidated financial institutions that are not deducted from CET 1 capital according to the relevant treatment of the exposure under the capital rules (i.e., for equity exposures, ranging from 100% for non-significant equity exposures to 300% or 400% for publicly traded and non-publicly traded equity exposures, respectively)
  - **Simplified Treatment of Minority Interests:** The proposal would permit the recognition of minority interests issued by consolidated subsidiaries up to 10% of the relevant tier of capital after all other deductions and adjustments, but before recognition of minority interests (i.e., up to 10% of the firm's CET 1 capital for CET 1 capital instruments issued by the subsidiary to third parties, up to 10% of the firm's Tier 1 capital for Tier 1 capital instruments issued by the subsidiary to third parties, etc.), and without having to calculate the extent to which the subsidiary's minority interests may reflect excess capital at the subsidiary.

Capital and Stress Testing

- **Replacement of HVCRE Exposures with HVADC Exposures:** The proposal would also replace, in the standardized approach for credit risk, the category of High Volatility Commercial Real Estate (**HVCRE**) exposures with a new category of High Volatility Acquisition, Development or Construction (**HVADC**) exposures, which among other changes would not include an exemption for contributed capital and would be risk weighted at 130% rather than 150%.
  - The change in treatment of HVCRE exposures mandated by the Bipartisan Banking Act (as described below on slide 35) effectively requires the banking agencies to rethink their approach to this aspect of the proposal.
- **Delay in Final Phase-in of Capital Rules for Non-Advanced Approaches Firms**: In November 2017, in keeping with the capital simplification proposal, the U.S. banking agencies finalized a rule to indefinitely delay, for non-advanced approaches banking organizations, the final phase-in step of the transition provisions of the capital rules that would be affected by the proposal.

Capital Standards Finalized by Basel Committee but Not Yet Implemented in the United States	
▪ Fundamental Review of the Trading Book (**FRTB**) ▪ Standardized Approach for Counterparty Credit Risk (**SA-CCR**) ▪ Interest Rate Risk in the 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 ▪ Revised assessment methodology published for G-SIBs ▪ Capital Floors for Credit Risk ▪ Unclear how Basel Committee capital floor standard would be implemented in the United States in light of the Collins Amendment, which effectively imposes 100% of standardized RWAs as a floor

Capital and Stress Testing

- **Statutory Developments:** The Bipartisan Banking Act makes the following changes to the **U.S. Basel III capital rules**:
  - **SLR for Custody Banks:** The Act directs the U.S. banking agencies to exclude certain central bank deposits from the total leverage exposure (the SLR denominator) of custody banks, defined as “depository institution holding companies predominantly engaged in custody, safekeeping and asset servicing activities,” together with their insured depository institution subsidiaries.
    - Central bank reserves of custody banks will be excluded only to the extent of the value of customer deposits that are linked to fiduciary, custody or safekeeping accounts.
    - Vice Chairman for Supervision Quarles noted in Congressional testimony that only the three custody banks will benefit from this provision because it is limited to banks that are "predominantly" engaged in custodial services.
  - **Community Bank Leverage Ratio / Off Ramp:** The Act directs the U.S. banking agencies to establish via rulemaking a community bank leverage ratio, and banking organizations that exceed this leverage ratio will be deemed to have met their applicable leverage ratios, risk-based capital ratios, well-capitalized minimums for prompt corrective action and any other applicable capital or leverage requirements.
    - A bank or BHC will qualify for the community bank leverage ratio if the bank or BHC has total consolidated assets of less than $10 billion.
    - The community bank leverage ratio will be defined as the ratio of a banking organization’s tangible equity capital to its average total consolidated assets and would be set between 8% and 10%.
  - **Capital Treatment of Commercial Real Estate Exposures:** The Act also changes the capital treatment of HVCRE exposures, preventing the U.S. banking agencies from applying a heightened 150% risk weight to an HVCRE exposure unless the exposure also falls within the definition of an **HVCRE ADC loan**, as newly defined in the Act. This change:
    - Effectively creates a specific statutory capital regulation requiring the U.S. banking agencies to align their rules with the new HVCRE ADC loan definition
    - Effectlively prevents the U.S. banking agencies from implementing the proposed replacement of HVCRE exposures with HVADC exposures, as contemplated in the September 2017 capital simplification proposal

Capital and Stress Testing

- The Bipartisan Banking Act makes the following changes to the **DFAST stress testing requirements**:
  - **Thresholds and Frequency of DFAST Company-Run Stress Tests:**
    - G-SIBs, BHCs, SLHCs, banks and savings associations with total consolidated assets of at least $250 billion will be subject to periodic, as opposed to annual, company-run stress tests.
    - The Federal Reserve will be able to designate a BHC with $100 billion to $250 billion in total consolidated assets to be subject to company-run stress tests.
    - BHCs with total consolidated assets of less than $100 billion will be exempt from company-run stress tests.
  - **Thresholds and Frequency of DFAST Supervisory Stress Tests:**
    - G-SIBs and BHCs with total consolidated assets of at least $250 billion will still be subject to annual supervisory stress tests.
    - BHCs with $100 billion to $250 billion in total consolidated assets (except any G-SIBs in this asset range) will be subject to periodic, rather than annual, supervisory stress tests.
      - The Federal Reserve will be able to designate a BHC with $100 billion to $250 billion in total consolidated assets to be subject to the annual supervisory stress test requirements applicable to G-SIBs and larger BHCs.
    - BHCs with total consolidated assets of less than $100 billion would be exempt from supervisory stress tests.
  - **Number of Dodd-Frank Act Stress Test Economic Scenarios:** The Act also reduces the required number of economic scenarios from three to two, eliminating the middle-of-the-road adverse scenario and leaving the baseline and severely adverse scenarios.
  - **Timing of CCAR and DFAST Threshold Changes:** The Federal Reserve exempted BHCs with less than $100 billion in total consolidated assets from both DFAST and CCAR for the 2018 cycle, as expected. The Federal Reserve's July 6 statement on the Bipartisan Banking Act confirmed its intention not to take any action to require BHCs with < $100 billion in total assets to comply with capital planning, supervisory stress testing or company run stress testing requirements.

Capital and Stress Testing

- **Other Potential Methods of Change:**
  - **Stress Buffer Requirements:** In April 2018, the Federal Reserve released a proposed rule on the implementation of the SBR that would fundamentally change how stress testing is used to impose 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 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 stress capital buffer.
    - 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.

For more information on SBR, please visit the FinReg blog – "Federal Reserve Proposes Stress Capital Buffer Requirements in Overhaul of CCAR" (April 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

- **Other Potential Methods of Change:**
  - **Recalibration of Enhanced SLR:** In April 2018, the Federal Reserve and OCC released a proposed rule on the recalibration of eSLR that 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 recent 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 eliminate U.S. goldplating relative to international standards.
    - Vice Chairman for Supervision Quarles stated in his April 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.
  - **CECL Methodology**: In April 2018, the FDIC, Federal Reserve and OCC released a proposed rule on the effects of a banking organization's adoption of the CECL methodology on regulatory capital and stress testing.

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" (April 17, 2018).

Capital and Stress Testing

- **Other Potential Methods of Change:**
  - In February 2018, the House passed H.R. 4296, which would place limitations on any operational risk capital requirement adopted by a U.S. banking agency, including by providing that any such requirement must be (1) based primarily on the risks posed by the banking organization’s current activities and business, as opposed to discontinued activities, and (2) appropriately sensitive to the risks posed by such current activities and businesses.

Liquidity

- **General Outlook:**
  - Net Stable Funding Ratio (**NSFR**) – proposed June 2016; Vice Chairman for Supervision Quarles stated during the Q&A after a May 16 speech that the Federal Reserve intends to propose a final rule in the near future.
  - LCR applicability to FBO IHCs? – An intermediate holding company (**IHC**) of a foreign banking organization (**FBO**) is not currently subject to the Liqudity Coverage Ratio (**LCR**) rule. However, the Federal Reserve stated in its 2014 final rule that it anticipates a future separate rulemaking to implement an LCR-based standard for the U.S. operations of all or a subset of FBOs with ≥ $50 billion in combined U.S. assets. They did not indicate whether such a future standard might apply to U.S. branches and agencies of FBOs.
- **Statutory Developments:** The Bipartisan Banking Act makes the following changes to the **U.S. Basel III liquidity rules**:
  - **Treatment of Municipal Securities under the LCR**: As required by the Bipartisan Banking Act, the U.S. banking agencies have released an interim final rule amending the LCR to expand the eligibility of investment grade municipal obligations as Level 2B high-quality liquid assets.

For more information on this topic, please visit the FinReg blog – "Federal Banking Agencies Relax LCR Treatment of Municipal Bonds in Line with EGRRCPA" (August 23, 2018).

TLAC

- **General Outlook:** There is demonstrable appetite at the Federal Reserve to streamline 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 cross-border resolution, 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 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.
  - 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 eliminate U.S. gold-plating relative to international standards.

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

Foreign Banking Organizations

- **General Outlook:** The Bipartisan Banking Act provides regulatory relief to FBOs under certain asset thresholds; the Treasury Banking Report recommends changes that would provide regulatory relief to nearly all FBOs now subject to EPS requirements, and it hints at a more dramatic shift to restoring the United States' traditional application of the principle of national treatment and limits on extraterritorial regulation of FBOs.
- **Statutory Developments:**
  - The Bipartisan Banking Act increases the statutory threshold for most of the Federal Reserve's EPS to $250 billion in total consolidated assets.
  - Early versions of the Act were silent as to which asset measure would be used for determining whether an FBO falls under this threshold—e.g., would the asset threshold be evaluated based on an FBO's global assets, combined U.S. assets or U.S. non-branch assets?
    - As passed by Congress, the Bipartisan Banking Act clarifies that nothing in the provision raising the EPS asset thresholds:
      - Affects the application of the Federal Reserve's existing EPS regulations to an FBO with $100 billion or more in global total consolidated assets
      - Limits the authority of the Federal Reserve to implement EPS with respect to, require the establishment of an IHC under, or tailor the regulation of an FBO with $100 billion or more in global total consolidated assets
- **Regulatory Developments:**
  - The Federal Reserve confirmed in a July 2018 policy statement that it will not take action to require any FBO with global total consolidated assets of less than $100 billion to comply with the general EPS requirements or with certain reporting, disclosure and recordkeeping requirements.
    - In an August 2018 letter to Vice Chairman for Supervision Quarles, a group of Senators, including members of the Senate Banking Committee, called on the Federal Reserve to provide U.S. IHCs of FBOs with "comparable regulatory treatment to U.S. BHCs of similar size and risk profile" under any rules implementing the Bipartisan Banking Act.

Foreign Banking Organizations

- In the preamble to the SCCL final rule, the Federal Reserve noted that it interprets the Bipartisan Banking Act to have “restrict[ed] the scope of application of most [EPS] . . . to . . . FBOs with $250 billion or more in total consolidated assets.”
- While the proposed SCCL rule would have applied to the U.S. operations and U.S. IHCs of FBOs with $50 billion or more in total consolidated assets, the final rule applies only to the U.S. operations and U.S. IHCs of FBOs with $250 billion or more in global total consolidated assets.
- The preamble to the SCCL final rule also noted that the Federal Reserve may, through a separate rulemaking, apply the SCCL to FBOs and U.S. BHCs with $100 billion or more but less than $250 billion in global total consolidated assets.
- The SCCL final rule also tailors credit exposure limits to U.S. IHCs of FBOs based on the global total consolidated assets of the U.S. IHC, as long as the FBO parent has at least $250 billion in global assets.

- **Other Potential Methods of Change:**
  - The Treasury Banking Report recommends:
    - Increasing the threshold at which an FBO’s U.S. IHC becomes subject to CCAR
    - Recalibrating EPS, such as liquidity and resolution planning requirements, to give greater weight to comparable home-country regulations and allowing for substituted compliance where home-country regulations are sufficiently comparable
    - 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
  - Those Treasury Banking Report recommendations could be effected by the Federal Reserve through revisions of its regulations (e.g., its CCAR and TLAC rules).
  - Vice Chairman for Supervision Quarles has stated that the Federal Reserve will continue to exercise its authority to apply the EPS to FBOs in a flexible manner where appropriate to accommodate differences in firms’ structures and risk profiles.
  - The EU proposal to require U.S. banking organizations to set up EU IHCs does not bode well for elimination of the U.S. IHC requirement, and the Treasury Banking Report specifically supports continuation of the requirement.

Foreign Banking Organizations

- The following chart summarizes the Federal Reserve's current approach to implementing the Bipartisan Banking Act with respect to FBOs based on their global total consolidated assets:

	FBO ≥ \$10B, < \$50B globally	**FBO ≥ \$50B, < \$100B globally**	**FBO ≥ \$100B globally**
Risk committee requirement	**Exempt**	Still Applies	Still Applies
DFAST company-run stress testing	**Exempt**	**Exempt**	Still Applies
Resolution planning	N/A	**Exempt**	Still Applies
Debt-to-equity limits	N/A	**Exempt**	Still Applies
Home country / Basel III risk-based and leverage capital, liquidity risk management and capital and liquidity stress testing requirements, as applicable	N/A	**Exempt**	Still Applies
Additional EPS requirements – e.g., TLAC, U.S. IHC – as applicable	N/A	N/A	Still Applies

Orderly Liquidation Authority

- **General Outlook:** There is a risk that Orderly Liquidation Authority (**OLA**) will be repealed and replaced by a new chapter 14 of the Bankruptcy Code, but reform seems more likely than repeal and replace.
  - In February 2018, the Treasury Department issued a long-awaited report in which it recommended significantly reforming—but not repealing—OLA, while also recommending 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."
  - In November 2017, Chairman Powell commented during his confirmation hearing that bankruptcy may not be sufficient to protect the economic health of the country under extreme stress conditions and a "backup in the form of something like [OLA]" is needed.
  - In May 2017, nearly 125 financial scholars co-signed a letter opposing the repeal of OLA.
    - The letter argued that bankruptcy is unable to provide a sufficient response to, and necessary planning for, the systemic risks that would be caused by a failure of a G-SIB.
  - Members of the European Parliament also met with Federal Reserve officials in July 2017, and pressured the U.S. to preserve OLA.
    - In explaining its recommendation to retain OLA in its February 2018 report, Treasury cited foreign regulators' concerns about "exclusive reliance on bankruptcy to resolve a U.S. financial company."
  - At a TCH/SIFMA conference on June 19, Senator Toomey stated that while he was still against OLA, he accepted that it would make sense to first reform the Bankruptcy Code and only later consider changes to or repeal of OLA.

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).

Orderly Liquidation Authority

- **Potential Methods of Change:**
  - 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, has passed the full House twice.
    - 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
      - Providing a safe harbor from avoidance actions for transfers of assets to recapitalize the operating subsidiaries
    - The Treasury OLA Report also recommends that Chapter 14 be added as a preferred alternative to OLA, not a replacement.
  - The repeal of the Orderly Liquidation Fund (**OLF**) provisions of OLA and possibly all of OLA itself could be attached to a budget reconciliation bill, which would require only 51 votes in the Senate to be passed.
  - A more modest alternative would be to amend OLA to impose clear limits on the FDIC's discretion, including its discretion to use the OLF for anything other than fully secured loans to recapitalized and otherwise solvent firms at premium rates; the Treasury OLA Report recommends such reforms.
  - The FDIC could issue additional guidance or regulations to clarify certain aspects of OLA, even absent a statutory change.

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:** The Federal Reserve and FDIC jointly issued proposed guidance for the U.S. G-SIBs' 2019 and subsequent living wills submissions on June 29, and additional proposed guidance is expected; the Treasury Banking Report supports the concept of actionable living wills but recommends modifications to ease the burden imposed on firms, in light of the policy goals of resolution planning.
- **Statutory Developments:** The Bipartisan Banking Act raised the total consolidated asset threshold for Section 165(d) living wills from $50 billion to $250 billion and would authorize the Federal Reserve to raise or lower the threshold in certain circumstances.
  - In a July 2 press release, the Federal Reserve and FDIC noted that, pursuant to the Bipartisan Banking Act, the Federal Reserve, in the next 18 months, will determine which firms with more than $100 billion but less than $250 billion in total consolidated assets will be subject to the living will requirement going forward.
    - In a July 18 speech, Vice Chairman for Supervision Quarles stated that most firms in this range "do not pose a high degree of resolvability risk" and thus the Federal Reserve "should consider scaling back or removing entirely resolution planning requirements" for these firms.
  - The Federal Reserve and FDIC announced on July 6 that they will not enforce resolution planning requirements in a manner inconsistent with the Bipartisan Banking Act while they amend relevant regulations; therefore, firms with less than $100 billion in total consolidated assets are no longer subject to the living will requirement.
  - The IDI solo rule is not affected by the Act.
- **Other Potential Methods of Change:**
  - The Treasury Banking Report recommends that the agencies move to a two-year cycle for living wills submissions, raise the $50 billion threshold through an FSOC recommendation, subject the living wills guidance and assessment framework to public notice and comment, and require feedback on living wills within six months.
    - Chairman Powell and Vice Chairman for Supervision Quarles and then-FDIC Chairman Gruenberg have expressed support for a two-year cycle; Vice Chairman for Supervision Quarles reiterated this support in his written statement submitted in advance of his April 17 testimony before the House Financial Services Committee.

Living Wills

    - The Federal Reserve and FDIC extended the deadline for the U.S. G-SIBs' next 165(d) filing to July 1, 2019 and did not identify any deficiencies in any of the U.S. G-SIBs 2017 165(d) plans.
  - The Treasury Banking Report also recommends that the FDIC be removed from the Section 165(d) living will process.
    - An alternative would be to eliminate the duplicative IDI solo rule, but the Treasury Banking Report does not make this recommendation and the Bipartisan Banking Act did not eliminate the IDI solo rule.
  - None of these proposals would impact the separate IDI solo rule.
- **Potential Methods of Change:**
  - On June 29, 2018 the Federal Reserve and FDIC issued and invited comments on proposed guidance for the 2019 and subsequent submissions of the U.S. G-SIBs' living wills.
  - Vice Chairman for Supervision Quarles had previously stated, in a May 16 speech and Q&A, that the Federal Reserve intends to subject all of the previous guidance provided to U.S. and foreign firms on their living wills to the public notice and comment process of the Administrative Procedure Act, including guidance on capital and liquidity adequacy and positioning.
  - Vice Chairman for Supervision Quarles has stated that he supports reducing the information burden of living wills submissions on "firms with less significant systemic footprints."
    - On July 2, the Federal Reserve and FDIC extended the deadline for living wills filers with a December 2018 deadline to December 2019.
  - On June 19, Chairman McWilliams, in her first public remarks since taking the helm of the FDIC, said that the regulators had "more work to do" with respect to living wills, including making living wills expectations clearer.
  - The Financial Institution Living Will Improvement Act, which passed the House in January 2018 with unanimous support and is included in JOBS 3.0, would also make many of the changes recommended in the Treasury Banking Report, including moving to a two-year submission cycle for the Title I plans and requiring feedback on submissions within six months.

For more information on the June proposed guidance, please visit the FinReg blog – "Federal Reserve and FDIC Issue Proposed Guidance on U.S. G-SIBs' 2019 Resolution Plan Submissions" (June 29, 2018).

Volcker Rule

- **General Outlook:** Changed by the Bipartisan Banking Act; will be further changed by proposed amendments to regulations and, potentially, additional legislation
- **Proposed regulatory changes:**
  - The agencies released proposed amendments to the Volcker Rule regulations on June 5, 2018.
  - Vice Chairman for Supervision Quarles emphasized in his public statement about the proposal that it was the five agencies' "best first effort", but that they expected to make further changes in response to public comments, which he expressly invited to be robust and said they would be considered seriously.
  - Statutory amendments in the Bipartisan Banking Act will be addressed in separate rulemaking.
- **Key elements of the proposed changes include:**
  - Definition of Trading Account changed to remove the Purpose Test and replace it with a new, more objective Accounting Test
    - Under the Accounting Test, transactions are for the trading account if recorded at fair value on a recurring basis under the applicable accounting standards, which includes derivatives and available-for-sale securities.
  - Three-tiered compliance system with banking entities classified based on the size of their trading assets and liabilities
    - Banking entities with "moderate" or "limited" trading assets and liabilities would be subject to fewer compliance obligations.
  - For underwriting and market-making activities, presumption of compliance with RENTD limitation if trading within internally set risk limits
  - Limited proposed amendments to covered funds portion of the regulations, but the agencies invited comment on a wide range of issues, including the definition of "covered fund" and whether the exceptions to the definition of covered transaction under section 23A of the Federal Reserve Act and Reg W should be incorporated into the definition of covered transaction under Super 23A
  - Elimination of Appendix B and modifications to Appendix A, including new qualitative informational requirements
- **See our visual memorandum here for further analysis of the proposed amendments**

Volcker Rule

- **The Bipartisan Banking Act:**
  - Enacts the community bank exemption:
    - Exempts from the Volcker Rule any IDI and any affiliate of an IDI that meets, and is not controlled by a company that does not *itself* meet, the following requirements:
      - ≤ $10 billion in total consolidated assets; and
      - Total trading assets and trading liabilities of 5% or less of total assets
- **Additional legislative change possible via congressional funding bill:**
  - On April 13, 2018, the House passed the Volcker Rule Regulatory Harmonization Act, which would amend the Volcker Rule to give the Federal Reserve sole rulemaking authority.
  - The House Appropriations financial services subcommittee approved a funding bill on May 24, 2018 that would do the same.

For additional information on the Volcker Rule's future and the Bipartisan Banking Act's impact on the Volcker Rule, please see our visual memoranda – "Proposed Amendments to the Volcker Rule Regulations" (June 18, 2018), "Bipartisan Banking Act Will Rebalance the Financial Regulatory Landscape" (May 22, 2018).

Community Reinvestment Act

- **Change is Coming:** Leadership at the Treasury Department, OCC, Federal Reserve and FDIC have strongly signaled support for revising the Community Reinvestment Act (**CRA**) regulatory framework and have outlined the themes that will shape that reform.

Treasury Department

- In April 2018, the Treasury Department issued a memo recommending that CRA reform efforts focus on updating assessment areas, improving the clarity, flexibility and timeliness of performance evaluations, and re-evaluating penalties for nonperformance.

The Banking Regulators: The OCC is the First Out of the Gate

- In August 2018, the OCC released an ANPR "to solicit ideas for building a new framework to transform and modernize" the current CRA regulatory framework to better achieve the statutory purpose of the CRA. Comments are due November 19, 2018.
  - The ANPR is closely aligned with both (1) the April 2018 Treasury Department memo and (2) Comptroller Otting's June 2018 testimony before the House Financial Services and Senate Banking Committees (see slide 53 for more details on Otting's framework for CRA reform).
  - While offering few concrete proposals, the ANPR asks questions relating to CRA performance evaluations, the definition of assessment area and CRA-qualifying activities.
  - Federal Reserve Vice Chairman for Supervision Quarles and FDIC Chairman McWilliams have expressed their support for CRA reform, but the fact that the Federal Reserve and FDIC did not join the OCC in issuing the ANPR hints these agencies may not fully agree with the OCC's approach.
  - Chairman McWilliams stated in an August interview that she supports a "revamp" of CRA implementation, including clarification of CRA-qualifying activities and review of small business loan qualifications, while citing the importance of serving community needs in rural communities in maintaining that branch location should still be taken into account.

For more information on the CRA, visit the FinReg blog – "CRA Reform: The OCC Is the First and (So Far) Only Regulator Out of the Gate" (Aug. 31, 2018) and "Treasury Offers Roadmap to CRA Reform" (Apr. 10, 2018).

Community Reinvestment Act

- The OCC has already implemented certain changes:
  - October 2017 revisions to the OCC's CRA rating policy, requiring a logical nexus between the assigned rating(s) and evidence of discriminatory or other illegal credit practices, have been clarified in an August 2018 policy bulletin. The August bulletin (which replaces the October 2017 bulletin) restates the logical nexus requirement, further emphasizes the consideration given to remedial actions, and states that, when relevant illegal practices are "found to be particularly egregious," exceptions may be made to the OCC's general policy of limiting ratings downgrades to one rating level.
  - Updates to CRA supervisory policy and processes in June 2018

For more information on the CRA, visit the FinReg blog – "CRA Reform: The OCC Is the First and (So Far) Only Regulator Out of the Gate" (Aug. 31, 2018) and "Treasury Offers Roadmap to CRA Reform" (Apr. 10, 2018).

Community Reinvestment Act

Comptroller Otting's Framework for CRA Reform

1 Expand CRA-Qualifying Activities

- **Principle:** Current CRA approach is too focused on residential lending
- **Desired Change**: Expand the products and services that qualify under the CRA; more consideration is needed for small business lending, student lending, economic development opportunities and short-term, small-dollar consumer loans

Otting stated his support for (1) Increasing the revenue cap for small business loans under the community development test and (2) Allowing some activities involving religious groups to qualify under the CRA.

2 Broaden Assessment Areas

- **Principle:** The current approach of determining assessment areas based on the geographic footprint of branches and ATMs is at odds with technological advancement in banking
- **Desired Change**: Determine assessment areas based on where services are provided; consider where customers and employees are located

3 Develop Metrics-Driven Evaluation Approach

- **Principle:** Evaluations are too subjective, are administratively burdensome and lack clarity and transparency
- **Desired Change**: Develop clearer metrics that can be applied consistently and serve as a more objective basis for examiner ratings; these metrics would facilitate transparency and would allow for more meaningful comparisons across banks

Otting suggested that a ratio could be used to help reflect a bank's commitment to the CRA.

$$\frac{\$\ \textbf{Total CRA Activities}}{\$\ \textbf{Total Assets or Total Tier 1 Capital}}$$

Community Reinvestment Act

- **Democratic Points of View:**
  - Federal Reserve Governor Brainard has spoken extensively about the CRA in recent months; while broadly agreeing with the need for change, she has struck notes of caution about certain aspects of potential reform.
    - In an April 2018 speech, Governor Brainard expressed support for tailored evaluation criteria based on bank size, a view that is at odds with Comptroller Otting's vision.
    - In May 2018, she stated that changes to assessment areas should be tailored to bank business models.
  - In a May 2018 letter to the Federal Reserve, OCC and FDIC, 16 Democratic senators led by Senator Mark Warner offered support for Treasury's recommendation to update geographic assessment areas but opposed adoption of the OCC's policies that permit banks with less than satisfactory CRA ratings to open or acquire new branches and require a direct relationship between a discriminatory or illegal credit practice and the bank's CRA lending activities for there to be a ratings impact.
  - In a July 2018 letter to Comptroller Otting, nine Democratic senators led by Senator Sherrod Brown expressed concern about recent changes to evaluation practices that they believe weaken CRA enforcement. They focused on the lengthening of the performance evaluation cycle for certain banks from 36 to 48 months and the policy of not delaying the issuance of CRA evaluations if pending matters involving potentially discriminatory practices cannot be resolved within 90 days.

Anti-Money Laundering

- **General Outlook:** While regulatory change is a high priority for Comptroller Otting, we still expect increased enforcement, with a focus on transparency and potentially on new financial technologies and platforms. Regulators will continue to focus on ultimate beneficial ownership of entities.
  - In recent years, bank supervisory agencies, including the NYDFS, have brought substantial enforcement actions for anti-money laundering (**AML**) violations, including violations of compliance standards.
    - Political and regulatory climate suggests that these efforts will continue, and potentially accelerate.
  - On May 11, 2018, FinCEN's Customer Due Diligence (**CDD**) rule became applicable after a two-year implementation period. The CDD Rule added a new requirement for covered financial institutions to identify, and verify the identity of, the beneficial owners of certain of their legal entity customers. It also clarified and enhanced CDD requirements for financial institutions.
  - In contrast, Congress continues to consider the scope and impact of the CDD rule, and the Counter Terrorism and Illicit Finance Act moving through Congress recently dropped its beneficial ownership requirement.
- **Potential Methods of Change:**
  - In February 2017, TCH published a report proposing a series of AML reforms, including having the Treasury's Office of Terrorism and Financial Intelligence take a more prominent role in coordinating AML policy across the government and having FinCEN reclaim sole supervisory responsibility for large financial institutions.
  - Strong policy imperatives continue to underlie the general federal AML framework. In May, federal banking regulators met to discuss improvements to the current AML laws and regulations.
    - In June 14 testimony before the Senate Banking Committee, Comptroller Otting stated that bank regulators and bankers "must continually adapt to increasingly sophisticated criminals and other illicit actors who take advantage of the nation's banks and financial system," and that AML laws and regulations need to be reformed "to be more efficient while improving the ability of the federal banking system."
    - In Secretary Mnuchin's July 12 testimony before the House Financial Services Committee, he stated that Congress had Treasury's "commitment to continue to work on" AML reform.

For more information on the CDD rule, please visit the FinReg blog – "FFIEC Issues New Procedures on Examining Financial Institutions for Compliance with FinCEN's CDD Rule, while FinCEN and Congressional Review Continues" (May 21, 2018).

Bank Secrecy Act

- **General Outlook:** Changes to the Bank Secrecy Act (**BSA**) and other AML rules are being seriously discussed. Regulatory change is a high priority, while legislative change is uncertain.
  - Comptroller Otting has made it clear that reform in this area is one of his top priorities, stating in his June 14 Senate Banking Committee testimony that the process for complying with current BSA/AML laws and regulations has become "inefficient and costly" and banks spend "billions each year" to comply with BSA/AML requirements.
- **Potential Methods of Change:**
  - The OCC, the Federal Reserve, the FDIC, the National Credit Union Administration and FinCEN are discussing potential changes to the BSA and other AML rules within the next three to six months, with an eye toward rationalizing compliance requirements for banks and other financial institutions. Such changes could include:
    - Allowing regulators to schedule and scope BSA/AML examinations on a risk-basis and identifying ways to conduct associated examinations in a more efficient manner
    - Considering changes to the threshold requiring mandatory reporting of Suspicious Activity Reports (**SARs**) and currency transaction reports and simplifying reporting forms and requirements
    - Working with law enforcement to provide feedback to banks so that they understand how SARs and other BSA report filings are used and can provide the most useful information
    - Exploring the use of technologies to reduce reporting burden and provide more effective access and information to law enforcement and national security personnel
- **NYDFS Rule 504:** On June 30, 2016, NYDFS issued Rule 504 requiring regulated institutions to maintain "Transaction Monitoring and Filtering Programs" reasonably designed to (1) monitor transactions after their execution for compliance with BSA and AML laws and regulations, including SAR requirements, and (2) prevent unlawful transactions with sanctions targets.
  - Rule 504 also required regulated institutions' boards of directors or senior officer(s) to make annual certifications to the DFS Superintendent confirming that they have taken all steps necessary to ascertain compliance with the program requirements and that, to the best of their knowledge, the Program complies with the Final Rule. These requirements went into effect on January 1, 2017, and regulated institutions were required to file their first annual compliance certification by April 15, 2018.

OFAC Sanctions

- **General Outlook:** Under the Trump Administration, there have been significant developments with respect to sanctions against Iran, Russia, North Korea and Cuba. The sanctions regimes against these countries have generally been strengthened through a combination of executive and legislative action.
  - The Countering America's Adversaries through Sanctions Act (**CAATSA**), which provides authority for additional sanctions against Iran, Russia, and North Korea, was signed into law on August 2, 2017.
- **Iran**
  - A rollback of the Iran nuclear deal – the Joint Comprehensive Plan of Action (**JCPOA**) and Iran sanctions – is currently underway.
  - On May 8, 2018, President Trump announced that he was terminating the United States' participation in the JCPOA with Iran and issued a National Security Presidential Memorandum directing his administration to immediately begin the process of fully reimposing sanctions that target critical sectors of Iran's economy, including the energy, petrochemical, and financial sectors.
    - Depending on the particular sanctions measure, the United States will provide either a 90-day or 180-day period in which activities permitted under or consistent with the JCPOA can be wound down.
    - Following the conclusion of the applicable wind-down period, persons engaged in such activities involving Iran will face exposure to secondary sanctions or enforcement actions under U.S. law.
    - The first wave of U.S. sanctions, concerning among other things, the purchase or acquisition of U.S. dollar banknotes by the Government of Iran, Iran's trade in gold or precious metals, significant transactions in Iranian rials, purchase of Iranian sovereign debt, importation into the U.S. of Iranian-origin carpets and foodstuffs and Iran's automotive sector, were reimposed on August 7, 2018. The EU responded by imposing a "blocking statute" designed to protect European businesses that trade with Iran and reiterated their commitment to the JCPOA.
    - After November 4, 2018, all U.S. sanctions (both primary and secondary) that had been waived or lifted under the JCPOA are expected to be reimposed and in full effect.

For more information on developments regarding economic sanctions, please visit the FinReg blog's Economic Sanctions section here, including – "President Trump Issues Executive Order Re-Imposing Iran Sanctions, Signals Aggressive Enforcement to Come" (Aug. 7, 2018) and "President Trump Withdraws from Iran Deal, U.S. Sanctions to Snap Back" After Limited Wind-down Period" (May 9, 2018).

OFAC Sanctions

- **Russia**
  - The Russia sanctions make up the bulk of CAATSA, which codifies existing sanctions on Russia and requires Congressional review of an attempt by the President to terminate, waive, or significantly modify current sanctions on Russia.
  - On January 29, 2018, the Trump Administration faced its first major Russian sanctions benchmark under CAATSA, and was to determine whether or not new sanctions were needed against those who conduct business with Russian defense and intelligence firms.
    - The State Department announced that the administration was declining to impose any new sanctions, stating that "[CAATSA] and its implementation are deterring Russian defense sales."
  - Additionally, Treasury released a report titled "Report on Senior Foreign Political Figures and Oligarchs in the Russian Federation" to Congress on January 29, 2018, as mandated by CAATSA.
    - Upon releasing the report, Treasury made explicit that it was not a sanctions list and those listed were not being subject to any sanctions, restrictions, prohibitions, or limitations.
  - On April 6, 2018, OFAC sanctioned seven Russian oligarchs and 12 companies they own or control, 17 senior Russian government officials, and a state-owned Russian weapons trading company and its subsidiary, a Russian bank under CAATSA.
    - Because a number of the parties sanctioned have dealings with U.S. persons and other companies throughout the world, it is likely that OFAC's action will cause significant business disruptions and compliance challenges for both U.S. and non-U.S. persons.
  - The first round of sanctions includes additional restrictions on the export of dual-use technologies and took effect on August 27.

For more information on developments regarding economic sanctions, please visit the FinReg blog's Economic Sanctions section here, including – "OFAC Further Expands, Extends, Russia-related General Licenses" (June 1, 2018) and "OFAC Targets Russian Oligarchs and Government Officials" (April 6, 2018).

OFAC Sanctions

- **North Korea**
  - On June 29, 2017, the Administration imposed sanctions and other measures on four Chinese individuals and entities, including a bank, for supporting North Korea's illicit activities. On September 21, 2017 the Administration issued a new Executive Order expanding the Treasury's authorities to target those who enable the North Korean regime's economic activity.
    - The full extent to which secondary sanctions are used to target China's economic support for North Korea remains to be seen.
    - On November 21, 2017, the Administration designated one individual, 13 companies, and 20 vessels in an action targeted at disrupting North Korea's funding of its nuclear and ballistic missile programs; certain of these designations constituted the imposition of secondary sanctions on non-U.S., non-North Korean entities and individuals.
  - In February 2018, the Administration announced the latest and "largest North Korea-related sanctions tranche to date…to further isolate the [North Korean] regime and advance the U.S. maximum pressure campaign." The sanctions include designations against seven Chinese and Hong Kong companies.
  - President Trump met Kim Jong-un in Singapore to discuss the security situation on the Korean Peninsula, including with respect to North Korea's nuclear and ballistic missile program, on June 12, 2018. The ultimate effect of this summit on North Korea sanctions is unclear.
- **Cuba**
  - President Trump announced Cuba sanctions policy changes in June 2017, which will reinstate certain limits on education travel and introduce new restrictions on transactions with entities controlled by the Cuban military and security services.
    - On November 8, 2017, OFAC and the Commerce Department's Bureau of Industry and Security announced amendments to the Cuban Assets Control Regulations and the Export Administration Regulations to implement the changes announced by President Trump in June.

Derivatives

- **General Outlook:** The OTC derivatives regime is unlikely to change significantly. Incremental changes at the regulatory level are expected through rulemakings, no-action letters and guidance.
- **CFTC Spots Now Filled with Trump Appointees**
  - With the swearing in of Dan Berkovitz and Dawn Stump as Commissioners of the CFTC in early September 2018, for the first time since 2014, there are no vacancies in the agency's five member commission. Chairman Giancarlo, who had been appointed to the CFTC by President Obama, was appointed by President Trump to the chairmanship, and all four of the other commissioners are Trump appointees.
    - Chairman Giancarlo has announced that he will not seek reappointment when his term expires in April 2019.
- **Significant Regulatory Initiatives**:
  - Since the election, the CFTC has:
    - Launched Project KISS (**Keep it Simple, Stupid**), an agency-wide internal review focused on simplifying and modernizing CFTC rules, regulations and practices, and issued a related request for public input
    - Initiated a comprehensive review of the CFTC's swap data reporting regulations
    - Established LabCFTC, an initiative aimed at promoting responsible fintech innovation
    - Issued determinations finding that the EU and Japanese margin requirements for uncleared OTC derivatives are comparable to the CFTC's uncleared swap margin rules
    - Issued an order providing that the current swap dealer *de minimis* threshold ($8 billion notional of dealing swaps) will remain in place until December 31, 2019

Derivatives

- **Recent Final Rulemakings**: In August 2018, as part of its Project KISS program, the CFTC approved a final rule that clarifies Chief Compliance Officer (**CCO**) roles and responsibilities, reduces burdens on CCOs and uncertainty for registrants, and harmonizes certain provisions with SEC rules.
- **Recent Rule Proposals**: The CFTC has proposed significant rulemakings in a number of areas, including:
  - In July 2018, as part of the Project KISS initiative to reduce unnecessary burdens on registrants and market participants, the CFTC issued a proposed rule that would amend reporting requirements to simplify notification of counterparties of their right to segregate initial margin for uncleared swaps and modify requirements for the handling of segregated initial margin.
  - In June 2018, the CFTC proposed a rulemaking that would make permanent the $8 billion temporary swap dealer *de minimis* registration threshold currently in effect and would make other changes to the *de minimis* exception.
- **Coordination with SEC**: In June 2018, the CFTC and SEC entered into a memorandum of understanding that "will help ensure continued coordination and information sharing between the two agencies" and specifically mentions cooperation regarding the Dodd-Frank Title VII swaps regime.
  - In his July 2018 testimony before the House Committee on Agriculture, Chairman Giancarlo noted his agreement with SEC Chairman Clayton to prioritize the harmonization of Title VII rules, dividing the issues into two categories – "[S]imple practical ones" including filing of forms and harmonizing margin requirements, which he expected could be completed within months; and longer term issues relating to harmonization around core requirements of swaps execution, swaps reporting and swaps clearing, which will require longer-range work.

For more information on CCO roles and responsibilities, please see the FinReg Blog – "CFTC Adopts Final Rule Amendments Simplifying CCO Duties and Annual Report Rules for FCMs, Swap Dealers and MSPs" (August 29, 2018). For more information on the de minimis *threshold proposal, please see our client memorandum – "CFTC Proposes Maintaining Swap Dealer* De Minimis *Registration Threshold at $8 Billion with Expanded Exceptions" (July 5, 2018).*

Derivatives

- **International Cooperation and Cross-Border Rules:**
  - In his recent speeches in Singapore, London and Tokyo, Chairman Giancarlo previewed his coming white paper, in which he will call for reforms to the CFTC's cross-border swaps approach. He noted that the current approach is overly-expansive, unduly complex and operationally impractical, and has resulted in more fragmented and less resilient financial markets. He was particularly critical of a substituted compliance regime that applies a rule-by-rule comparison of CFTC and non-U.S. rules, rather than a more outcome-based approach. He stated that an improved approach would focus on mitigating systemic risk transfer across borders, while affording regulatory deference to trading jurisdictions that have adopted comparable swaps reforms.
- **Treasury Capital Markets Report**: The CFTC's actions to date are largely consistent with recommendations in the Treasury Capital Markets Report. Key recommendations in the Treasury Capital Markets Report include:
  - Adoption of an interaffiliate exemption from IM requirements for prudentially regulated swap dealers, harmonization of international margin requirements and adoption of other incremental changes to the uncleared swap margin rules that would provide relief on key operational challenges
  - Reliance on greater deference to non-U.S. regulatory regimes and implementation of an outcomes-based substituted compliance regime
  - Maintenance of the swap dealer *de minimis* registration threshold at $8 billion
  - Reconsideration of whether transaction-level requirements should apply to transactions between non-U.S. firms that are arranged, negotiated or executed by U.S. personnel
  - Adoption of swap trading rule changes to provide additional flexibility in the manner in which swaps are executed
  - Improvement of swap reporting requirements and processes in line with the CFTC's Roadmap
  - Resolution of unnecessary inconsistencies and duplication between swap and security-based swap rules, including granting interagency substituted compliance for any areas where effective harmonization is not feasible
  - Holistic review of CFTC and SEC guidance and relief, with the aim of formalizing into rulemaking

Parity in Capital Markets Regulation

- **Statutory Developments:** The **Bipartisan Banking Act** makes the following capital markets reforms:

  National Securities Exchange Parity

  - The Act amends Section 18 of the Securities Act of 1933 to apply the exemption from state regulation of securities offerings to securities listed or authorized for listing on a national securities exchange.
  - Before the Act, national securities exchanges were required to evidence that their listing standards were substantially similar to those of the NYSE, NYSE American or Nasdaq in order for those securities to be exempt from such state regulations.
  - This amendment facilitates the creation of innovative listing standards on new national securities exchanges and new tiers on existing national securities exchanges.

  Parity for Closed-End Companies Regarding Offering and Proxy Rules

  - The Act makes available to listed or hybrid closed-end funds the streamlined securities offering rules currently in place for operating companies under the SEC's Securities Offering Reform rules, such as the shelf registration and WKSI rules.
- **The FAIR Act** makes the following capital markets reforms:
  - Parity for covered investment fund research with research on corporate issuers by requiring the SEC to create a safe harbor from research published by broker-dealers on investment funds from being deemed an "offer" under the securities laws, even if the broker-dealer participates in a registered offering of the investment fund's securities
  - Covered investment funds include exchange traded funds (**ETFs**), mutual funds, registered closed-end funds and business development companies.
  - In implementing the safe harbor, the SEC must also prohibit a self- regulatory organization from maintaining or enforcing a rule that would prevent a member from (1) publishing or distributing a covered fund research report solely because the member is also participating in a registered offering of the fund, or (2) participating in a registered offering of a covered fund solely because the member has published a research report about the fund.
  - The Act also restricts the SEC from imposing certain conditions on the safe harbor.
- The SEC proposed rules to implement the FAIR Act in May of 2018.

Executive Compensation

- **General Outlook:**
  - The Core Principles suggest that the proposed rules on financial institution incentive compensation, dating from 2016 and involving six agencies, are unlikely to be approved in their final form.
  - In a January 22, 2018 speech, SEC Chairman Clayton stated his belief in a “serial approach” to Dodd-Frank mandated executive compensation rules and identified themes to consider in addressing such rules: “true to the statutory mandate, practical, and intended to help companies reduce compliance costs.”
  - In a May 21, 2018 meeting attended by SEC Division of Corporation Finance Director Hinman, SEC staff said that they anticipate finalizing the proposed Dodd-Frank hedging disclosure rule by sometime in April 2019.
  - On August 15, 2018, Senator 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 the receipt of such compensation, and for three years after a stock buyback, in order to disincentivize such corporations from awarding equity compensation and using stock buybacks to increase executive compensation. Prohibited cash-outs would incur a civil penalty.
  - Post-Dodd-Frank bills have included provisions that would repeal the statutory basis for financial institution incentive compensation, pay ratio and hedging provisions and limit the scope of the clawback and say-on-pay provisions.
- **Changes on the Tax Front:**
  - On August 21, 2018, the IRS issued limited guidance on the Tax Cuts and Jobs Act’s elimination of the “performance-based compensation” exception from the Section 162(m) limit on the deductibility of compensation to any covered employee. The guidance clarifies the scope of a “covered employee” and the grandfather for written binding contracts in place on or before November 2, 2017. The IRS’s guidance will be incorporated into future Section 162(m) regulations, which will apply to any taxable year ending on or after September 10, 2018.

For more information on the SEC pay ratio rule, please see the Davis Polk Client Memorandum – First Wave of Pay Ratio Disclosures Filed (Mar. 7, 2018). For more information on the Tax Cuts and Jobs Act’s impact on Section 162(m) compensation, please see the Davis Polk Client Memorandum – Administering Compensation Programs in the Wake of the Tax Cuts and Jobs Act – New Section 162(m) (Jan. 31, 2018).

Regulation Best Interest

- **General Outlook:** As of June 21, 2018, the Department of Labor's fiduciary rule has been vacated in its entirety. The SEC has proposed rules and interpretations (**Regulation Best Interest**), which are open for public comment and seek to enhance the standard of conduct of broker-dealers and investment advisers when they interact with retail investors.
- In a statement on the legislation on August 22, 2018, SEC Chairman Clayton stated that main street investors' primary concerns are:
  - That investment professionals will exercise appropriate care in making recommendations and will not put their interests ahead of the interests of their customers
  - Receiving easy to understand customer relation disclosures (such as those that include the use of graphics)
  - That there are no "questionable" sales practices such as high-pressure, product-based sales contests
- On September 12, 2018, Congressional Democrats sent a letter to Chairman Clayton urging the SEC to revise Regulation Best Interest "consistent with [Dodd-Frank] and require brokers to abide by the same high standard that currently applies to investment advisers so that their advice to retail investors is provided without regard to their financial and other interests," which the letter states the current version of the proposed rule fails to do.
  - The letter was written by Rep. Waters, Rep. Scott, Sen. Brown and Sen. Murray and was co-signed by 31 additional Democrats.
- **Regulation Best Interest: Broker-Dealers**
  - Under the proposed regulation, a broker-dealer or associated person would be required to act in the "best interest" of the retail customer at the time the recommendation is made, without placing the financial or other interests of the broker-dealer or associated person ahead of the interest of the retail customer.

For more information on Regulation Best Interest, please see the Davis Polk Client Memorandum – "SEC Proposes Enhanced Standards for Advice to Retail Investors" (May 7, 2018).

Regulation Best Interest

- The SEC did not provide a definition for "best interest." To meet the best interest standard broker dealers must do the following:
  - Disclose in writing, prior to or at the time of the recommendation, the material facts relating to the scope and terms of the relationship with the retail customer, including all material conflicts of interest that are associated with the recommendation
  - Exercise reasonable diligence, care, skill, and prudence to:
    - Understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers
    - Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's specific investment profile and the potential risks and rewards associated with the recommendation
    - Have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile
- To meet the best interest standard, broker dealers must also:
  - Establish, maintain, and enforce written policies and procedures reasonably designed to:
    - Identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations
    - Identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations

For more information on Regulation Best Interest, please see the Davis Polk Client Memorandum – "SEC Proposes Enhanced Standards for Advice to Retail Investors" (May 7, 2018).

Regulation Best Interest

- **Regulation Best Interest: Investment Advisers**
  - For investment advisers, the proposed regulation seeks to reaffirm, and in some cases clarify, certain aspects of the fiduciary duty that an investment adviser owes to its clients under Section 206 of the Advisers Act in a single release.
  - This release would seek to restate clearly the fundamental elements of an investment adviser's duty of loyalty and duty of care, including duties to provide advice that is:
    - In the client's best interest
    - To seek best execution
    - To act and to provide advice and monitoring over the course of the advisory relationship
    - To put its clients' interests ahead of its own
  - While most, if not all, of the above is familiar, it is notable that the SEC has sought to compile in a single interpretation a wide body of law that is dispersed across numerous rules, court decisions, SEC releases and other guidance.

For more information on Regulation Best Interest, please see the Davis Polk Client Memorandum – "SEC Proposes Enhanced Standards for Advice to Retail Investors" (May 7, 2018).

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 is uncertain, and providing banking services to such businesses has therefore been considered too perilous by most large institutions. As additional states move toward legalized marijuana sales in 2018, the next measure of relief may be legislative. As more states and Canada legalize cannabis, those banks who are complying with federal law and avoiding the sector will face increased diligence burdens.
- **The SAFE Acts**
  - Legislative proposals in both the House and Senate targeted at providing clarity to depository institutions have attracted bipartisan support:
    - The Secure and Fair Enforcement Banking Act of 2017 (**House SAFE Act**), most recently introduced by Rep. Perlmutter in April 2017, now has 88 co-sponsors, including 12 Republicans.
    - The Senate version of the Secure and Fair Enforcement Banking Act (**Senate SAFE Act**) introduced by Sen. Merkley in May 2017, and reintroduced, though not successfully, as a proposed amendment to the Bipartisan Banking Act during Senate consideration in March 2018, now has 14 co-sponsors, including three Republicans.
  - Although not identical, the House SAFE Act and Senate SAFE Act both prohibit federal banking regulators from:
    - Terminating a depository institution's deposit insurance solely because the institution provides financial services to a "cannabis-related legitimate business" operating pursuant to state law
    - Prohibiting a depository institution from providing financial services to such a business or to a state exercising jurisdiction over such businesses, or penalizing a depository institution for doing so
    - Recommending or incentivizing a depository institution not to offer financial services to certain account holders involved in such businesses
    - Taking certain adverse actions on loans to such businesses or to owners of real estate or equipment leased to such businesses

Cannabis-Related Banking

- **The SAFE Acts**
  - The bills provide protection from forfeiture of collateral for loans to such business or to owners of real estate or equipment leased to such businesses and from liability under Federal law for providing financial services to such businesses.
  - The Senate Safe Act includes providers of financial services, including ETFs and retirement plans, related to cannabis, and providers of other business services relating to cannabis, in the definition of "cannabis-related legitimate business".
- **The STATES Act**
  - In June 2018, Senators Warren and Gardner introduced the bipartisan Strengthening the Tenth Amendment Through Entrusting States Act (**STATES Act**), which would go further than the House and Senate SAFE Acts by clarifying federal law in general with respect to states that have legalized marijuana by providing that the Controlled Substances Act would not apply to marijuana-related conduct that is legal under state law.
  - The STATES Act would also explicitly protect the banking sector by providing that:
    - The proceeds of any marijuana transaction conducted in compliance with state law would not be deemed the proceeds of an unlawful transaction under the Money Laundering Control Act or any other provision of law, and
    - Marijuana-related conduct that is legal under state law would not serve as a basis for criminal or civil asset forfeiture.

For more information on the STATES Act, please visit the FinReg blog – "Bipartisan Marijuana Bill Would Permit Banking Legal Cannabis Businesses" (June 13, 2018).

Fintech Charters

- **General Outlook:** Different views on approach and an intense stakeholder scrum developing. Major developments from Treasury and the OCC were issued in late July.
- **Potential Methods of Change:**
  - **Charter**
    - On July 31, the OCC announced that it would begin accepting applications for special purpose national bank charters from nondepository fintech companies engaged in the business of banking.
    - The release of the OCC's July 31 policy statement and accompanying licensing manual supplement has already drawn criticism from the NYDFS and Conference of State Bank Supervisors, who had separately previously sued the OCC over its 2016 proposal to issue such charters. Both suits were dismissed as speculative. The NYDFS filed a new suit against the OCC on September 14, which again seeks a declaration that the OCC exceeded its authority under the National Bank Act and violated the U.S. Constitution's 10th Amendment by usurping powers belonging to states.
  - **Sandbox**
    - Talk of a regulatory sandbox for fintech firms has been reenergized
      - The CFPB and CFTC recently stated that they are jointly developing a regulatory sandbox for fintechs.
  - **Treasury Report**
    - The Treasury Fintech Report, issued on July 31, addressed the U.S. financial regulatory approach to nonbank financial institutions, financial technology and financial innovation.
    - The report, in key parts, endorsed the OCC's fintech charter and recommended a joint federal and state regulatory sandbox.

For more information on these topics, please visit the FinReg blog – "Treasury Calls for Banking Regulators to Harmonize and Modernize Permissible Activities of Banking Organizations" (Aug. 13, 2018), "Treasury Tailored R&R – New and Important for Fintech Charters" (Aug. 6, 2018) and "Treasury Fintech Report Addresses Wide-Ranging Topics with Reform Recommendations" (July 31, 2018).

Cybersecurity

- **General Outlook:** Cybersecurity is a high-priority item for legislators and regulators at the federal and state levels, as well as internationally.
- **Federal Approaches to Reform**: Both legislative and regulatory

Legislative

- On May 24, 2018, the Senate Banking Committee held a hearing on "Cybersecurity: Risks to Financial Services Industry and Its Preparedness" and Chairman Crapo stated that "[t]he collection and use of [personally identifiable information] will be a major focus of the Banking Committee moving forward…"
- Various legislation to address data security has been introduced, but not yet approved, by Congress.
  - On September 7, 2018, Representative Luetkemeyer introduced a bill that would amend Gramm-Leach-Bliley to provide a national standard for data security and breach notification. The bill was reported favorably out of the House Financial Services Committee, with the vote split on party lines, on September 13, 2018.

Regulatory

- Cybersecurity is a 2018 supervision and examination priority for the OCC, the FDIC and the SEC.
  - On April 24, 2018, the SEC announced the settlement of its first ever enforcement action against a company for an alleged failure to disclose a cybersecurity breach.
- On February 21, 2018, the SEC released updated interpretive guidance, available here, regarding disclosure of cybersecurity risks and incidents and noting the implications of cybersecurity incidents for insider trading compliance.
- On April 19, 2018, Federal Reserve Vice Chairman for Supervision Quarles testified before the Senate Banking Committee that cyber risk is "one of the most significant, if not the most significant risk that faces the financial sector currently," but that it is also "the issue…that we have most to do on."

- **State Approaches to Reform**: Primarily legislative
  - As of March 2018, all 50 states now have data security laws with breach notification provisions.
  - The NYDFS cybersecurity regulations (23 NYCRR 500) remains a model for state financial regulators.

For more information on cybersecurity, please visit our Cyber Breach Center.

Cybersecurity

- **International Approaches to Reform**: Both legislative and regulatory
  - The EU's General Data Protection Regulation became effective on May 25, 2018.
  - The Canada Digital Privacy Act will become effective on November 1, 2018.
- **Other Potential Methods of Change:**
  - Federal data security and breach notification proposals have been introduced in Congress by both parties over the last few years.
    - Although such proposals were ultimately unsuccessful, Treasury's primary recommendation for data security and breach notification, as stated in the Treasury Fintech Report, is for Congress to pass a federal law governing both.
  - The FSOC 2017 Annual Report recommends that the federal regulators harmonize cybersecurity supervision and regulation and that Congress pass legislation granting examination and enforcement authority to the SEC, CFTC, FHFA, and NCUA to oversee third-party service providers.
  - The Treasury Banking Report recommends that federal and state financial regulatory agencies coordinate regulation across sub-sectors.
  - Congress could amend the Cybersecurity Information Sharing Act of 2015 or create a new, more business friendly law altogether.
- **Trends across state, federal, and international laws and regulation:**
  - Shortened breach notification timelines
  - Incident response preparedness, including an emphasis on training and oversight at the Board level
    - Treasury recently published a tabletop exercise template for small and mid-size financial institutions
  - Data minimization, including disposal of information that is no longer necessary for business purposes

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