Financial Services Regulatory Reform

NEW CONGRESS EDITION

March 1, 2019

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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Momentum for Change Will Continue to be Agency-Driven

Financial regulatory reform, reflecting recent statutory mandates and the perspectives of the current administration and agency leadership, will continue to occur through a mix of regulations, interpretations and guidance, with the courts engaged by stakeholders on all sides.

State of Play: The New Congress	
Congressional Priorities	• Both the new Chairwoman of the House Financial Services Committee, Rep. Waters, and the returning Chairman of the Senate Banking Committee, Sen. Crapo, have been vocal about their legislative agendas for the new Congress. • Both committees are expected to focus on sanctions, GSE reform, financial services innovation and credit reporting. Chairman Crapo has also previewed a focus on capital formation and data privacy and security, while Chairwoman Waters has emphasized consumer protection and diversity initiatives, including by creating a new subcommittee. • We expect a sharply partisan backdrop of Congressional investigations and communications across a range of issues.
Legislative Implementation	• The Economic Growth, Regulatory Relief, and Consumer Protection Act (**EGRRCPA**), enacted in May 2018 with significant bipartisan support, impacts a number of areas of financial regulation, and its implementation has been high on agency leaders' agendas since its passage. • The prospects for passage of further reform legislation in the next two years are uncertain in the now-divided Congress. Proposals are already emerging, but concrete progress will be seen only in those limited areas with bipartisan support or where there is an appetite for extensive negotiation and compromise.
Regulators Forge Ahead	• Even absent additional legislation, the federal agencies have a full roster of regulatory reform priorities and new initiatives to complement ongoing efforts to implement statutory mandates, including EGRRCPA, and the finalization of Basel III. The agencies can expect extensive scrutiny from both sides of the aisle • The agencies' agendas will likely continue to be informed by the Treasury Department reports (**Treasury Reports**) on the conformity of U.S. financial regulations to the core principles (**Core Principles**) enumerated by President Trump in a February 2017 Executive Order, links to which are provided in the APPENDIX.

Rating Systems and Governance

- **General Outlook:** The Federal Reserve is expected to finalize this year a set of recalibrated supervisory expectations for boards of directors (**Board Effectiveness Guidance**), senior management, the management of business lines and IRM (**Management Guidance**). Our visual memorandum discussing the proposed Board Effectiveness Guidance and Management Guidance in detail is available here.
- **Five Key Attributes:** The proposed Board Effectiveness Guidance identifies five key attributes of effective boards.
- **LFI Rating System:** When finalized, the Board Effectiveness Guidance and Management Guidance will be used to inform the governance and controls component of the Federal Reserve's new rating system for large financial institutions (**LFIs**). Until then, an LFI will be evaluated for purposes of the governance and controls component based on existing supervisory guidance.
- **CAMELS Ratings:** Separately, the FFIEC is reviewing the CAMELS ratings system used to assign ratings to insured depository institutions, which was last updated in 1996. FDIC Chairman McWilliams, also the Chairman of the FFIEC, has explained that she requested this review to determine whether revisions are necessary in order to ensure consistency in the assignment of CAMELS ratings to national banks, state member banks and nonmember banks, thus discouraging forum shopping.

Proposed Board Effectiveness Guidance – Five Key Attributes
1. Set clear, aligned and consistent direction regarding firm's strategy and risk tolerance
2. Actively manage information flow and board discussions
3. Hold senior management accountable
4. Support the independence and stature of the firm's independent risk management and internal audit functions
5. Maintain a capable board composition and governance structure

Examinations

- **There is a consensus among banking regulators that examination and supervision needs to be more efficient, modern and fair.**
  - Vice Chairman for Supervision Quarles has stated regulatory efficiency could "mean simpler examination procedures for bank supervisors, or less intrusive examinations for well managed firms."
  - FDIC Chairman McWilliams' "Trust Through Transparency" initiative aims to "transform the FDIC – in terms of technology, examination processes, and culture – to enhance the stability of the financial system, protect consumers, and reduce the compliance burden on regulated institutions."
- **These sentiments echo the Treasury Report issued in June 2017, *A Financial System that Creates Economic Opportunities: Banks and Credit Unions* (Treasury Banking Report), which recommended that regulators:**
  - Improve the coordination of their examination activities and rationalize their examination and data collection procedures to promote accountability and clarity
  - Conduct an inter-agency reassessment of the volume of matters requiring attention (**MRAs**), matters requiring immediate attention (**MRIAs**), and consent orders
  - Develop an improved approach to clearing regulatory actions to reduce multiyear delays
- **As part of their long-term Examination Modernization Project, the FFIEC members (the Federal Reserve, FDIC, NCUA, OCC and the CFPB) have been focusing their initial efforts on:**
  - Highlighting and reinforcing regulator communication objectives before, during, and after examinations
  - Leveraging technology and shifting, as appropriate, examination work from onsite to offsite
  - Continuing to tailor examinations based on risk
  - Improving electronic file transfer systems to facilitate the secure exchange of information between institutions and supervisory offices or examiners

For more information on the FDIC's "Trust Through Transparency" initiative, please visit the *FinReg* blog – "*A Breath of Fresh Air at the FDIC*" (October 5, 2018).

Examinations

- **In February 2018, the Federal Reserve proposed to streamline and expedite the process for appealing material supervisory determinations (MSDs) by:**
  - Reducing the levels of appeal from three to two and requiring that each appeals level be overseen by independent review panels
  - Establishing an accelerated appeals process for MSDs, such as loan reclassifications, that cause an institution to become critically undercapitalized
  - Including extensive provisions to protect banking organizations against retaliation by Federal Reserve staff for exercising the right to appeal, although uncertainty remains whether such provisions can ever be truly effective
- **The Supervision and Regulation Report issued in November 2018 confirmed the Federal Reserve's continuing commitment to paradigmatic reform of transparency in examination and supervision.**
  - The Federal Reserve reiterated its commitment to reforming the examination appeals process.
  - The data included aggregate ratings and supervisory actions for banking organizations by type—large, foreign, community and regional—and revealed that the number of outstanding MRAs and MRIAs have generally decreased, except with respect to large foreign banking organizations (**FBOs**), which have seen MRAs and MRIAs increase due to regulatory changes that require changes to their U.S. structures.
  - Firms have improved in areas such as capital planning and liquidity management but continue to need improvement in risk management areas such as compliance, internal controls, model risk management, operational risk management and IT infrastructure.
  - Some firms continue to exhibit weaknesses in BSA/AML programs, which sometimes have longer remediation timelines.

For more information on the Federal Reserve's proposal, please visit the *FinReg* blog – *"Legal Interpretations in Examination Appeals Should be More Transparent"* (April 30, 2018).

GSE Reform

- **General Outlook:** Perhaps, finally, momentum may be building toward serious attempts at reform of government-sponsored enterprises (**GSEs**). Targeted administrative changes seem more probable than wholesale legislative reform, particularly in light of the upcoming election.
  - OCC Director Otting is serving as Acting Director of the Federal Housing Finance Agency (**FHFA**). In a party-line vote, the Senate Banking Committee has advanced the nomination of Mark Calabria to serve as FHFA director.
  - During the Senate Banking Committee hearing on his nomination, Calabria stated that, while the FHFA can make certain changes, the "fundamental things . . . have to be changed by Congress."
    - In addition, Calabria expressed support for preserving the 30-year fixed-rate mortgage, a change from his previous position that it should be eliminated. He also expressed support for introducing more competition into the housing finance market.
- **Potential Methods of Change:**
  - **Legislative:** In February 2019, Senate Banking Committee Chairman Crapo released an outline for housing finance reform legislation.
    - The framework would, among other things, convert Fannie Mae and Freddie Mac into private guarantors, assign responsibility for providing a catastrophic backstop to Ginnie Mae, and allow other guarantors to enter the market.
    - Senator Crapo's outline broadly aligns with a bill introduced in the House in September 2018 by outgoing Financial Services Committee Chairman Hensarling and others.
  - **Administrative**
    - The FHFA could reduce the GSEs' footprint by, for example, lowering the share of loans that qualify for GSE support and/or changing credit requirements.
    - In addition, Treasury and the FHFA could agree to stop the net worth sweep or otherwise make arrangements to allow the GSEs to rebuild capital.

Agency Deference

- **General Outlook:** Potential changes to the level of deference courts are required to give to agency interpretations are on the horizon.
- **Chevron Deference:**
  - Under *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, courts must defer to an agency's interpretation of ambiguous statutory language, provided that interpretation is reasonable.
  - Following recent changes in the composition of the Supreme Court, including the appointments of Justices Kavanaugh and Gorsuch, the future of *Chevron* deference has been called into question.
- **Auer Deference:**
  - In the more immediate future, the Supreme Court will in late March 2019 hear *Kisor v. Wilkie*.
    - In *Kisor*, the Court will decide whether to overrule *Auer v. Robbins* and *Bowles v. Seminole Rock & Sand Co.*, which direct courts to defer to an agency's reasonable interpretation of its own ambiguous regulation.
    - A decision is expected by June.

For more information on Justices Gorsuch and Kavanaugh's views on Chevron deference, please see the Davis Polk Client Memoranda – *"U.S. Supreme Court Confirmation of Justice Neil Gorsuch and Potential Future Impacts on Environmental Laws and Regulations"* and *"What Would a U.S. Supreme Court Confirmation of Judge Kavanaugh Mean for Environmental Regulation?"*

CFPB: Constitutional Challenges

- **General Outlook:** Appeals challenging the constitutionality of the CFPB's structure are pending in multiple circuits, including the Second, Fifth and Ninth Circuits. We believe a circuit split on the constitutionality of the CFPB's structure, followed by Supreme Court review when a proper vehicle arises, is increasingly likely.
- **Judicial Developments:**
  - In June 2018, 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 majority opinion of the D.C. Circuit, sitting *en banc*, in *PHH v. CFPB*. On September 14, 2018, the CFPB filed a notice of appeal to the Second Circuit.
  - Judge Preska adopted much of the dissent of Judge Kavanaugh, then a D.C. Circuit judge and now a Supreme Court Justice, in *PHH* to find that the structure of the CFPB—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, however, Judge Preska found that the specific unconstitutional provision is not severable from the remainder of Title X of the Dodd-Frank Act, 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."
  - In *State National Bank of Big Spring v. Mnuchin*, the D.C. Circuit affirmed the D.C. District Court's entry of judgment against the plaintiffs on their constitutional challenge to the CFPB, citing *PHH*. On December 10, 2018, the Department of Justice (**DOJ**) filed a brief opposing Big Spring's petition for a writ of certiorari in which the DOJ agreed that the current structure of the CFPB is unconstitutional, but ultimately argued the case was a poor vehicle for the Supreme Court to consider the constitutionality of the CFPB's current structure. The Supreme Court denied certiorari on January 14, 2019.

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).*

CFPB: Constitutional Challenges

- One of the pending challenges to the CFPB's structure is awaiting oral argument in the Fifth Circuit. In that case, *CFPB v. All American Check Cashing, Inc.*, the CFPB brought an enforcement action against All American in the Southern District of Mississippi. On March 21, 2018, United States District Judge Barbour denied All American's motion for judgment on the pleadings, relying on *PHH* in rejecting All American's argument that the CFPB is unconstitutionally structured. On April 24, 2018, the Fifth Circuit granted All American's motion for leave to appeal from Judge Barbour's interlocutory order. Oral argument is currently scheduled for March 12, 2019.
- We also note the July 2018 Fifth Circuit *per curiam* decision in *Collins v. Mnuchin*, which included a claim that the FHFA is "unconstitutionally structured because . . . it is headed by a single Director removable only for cause." In finding that the FHFA is unconstitutionally structured, the Fifth Circuit stated that agencies "may be independent, but they may not be isolated," that courts "must look at the aggregate effect of the insulating mechanisms," and repeatedly cited the dissents of Judges Kavanaugh and Henderson in *PHH*. On November 12, 2018, the Fifth Circuit ordered that Collins be reheard by the court en banc. On January 14, 2019, the FHFA under new Acting Director Joseph Otting indicated that it will no longer defend the constitutionality of the for-cause removal protection of FHFA directors.

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

Tailored Regulation

- **General Outlook:** EGRRCPA requires regulation and supervision to be tailored to a banking organization's business model and risk profile by raising asset size thresholds for many requirements.
  - EGRRCPA raised 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 and single-counterparty credit limits (**SCCL**).
  - On October 31, the Federal Reserve released proposed rules to tailor EPS for U.S. firms above $100 billion in assets and the U.S. banking agencies proposed corresponding tailoring changes to their capital and liquidity rules. **See our visual memorandum here for a detailed analysis of the Federal Reserve's proposed rules.**
  - Under the proposed rules, the requirements applicable to a firm would depend on which of the following Categories the firm falls into:
    - **Category I** – U.S. G-SIB
    - **Category II** – Either:
      - ≥ $700 billion in assets; or
      - ≥ $75 billion in cross-jurisdictional activity
    - **Category III** – Either:
      - ≥ $250 billion in assets; or
      - ≥ $75 billion in one of nonbank assets, weighted short-term wholesale funding or off-balance sheet exposures
    - **Category IV** – Any other firm with ≥ $100 billion in assets

Tailored Regulation

- The proposed rules would also apply EPS to certain non-insurance SLHCs that qualify as a Category I, II, III or IV firm.
  - Currently, covered SLHCs are subject to regulatory capital requirements and the LCR but are not subject to capital planning, supervisory DFAST and other EPS requirements applicable to similarly sized BHCs.
- Still to come:
  - Proposed tailoring changes to capital planning rule
  - Proposed tailoring of EPS, capital and liquidity rules applicable to U.S. intermediate holding companies (**IHCs**) and U.S. subsidiaries of FBOs
    - In his November 2018 testimony before the House Financial Services Committee, Vice Chairman Quarles emphasized that FBOs are "a different [breed of] cat" than U.S. banking organizations, suggesting that the categorization thresholds in the FBO proposal may be different than those proposed for U.S. firms.
  - Proposed tailoring changes to resolution planning rules
- In Representative Waters' November 9, 2018 letter, she noted that "Democrats are [also] concerned about preserving small community financial institutions," signaling that regulatory tailoring for community banks and credit unions could continue in 2019.
- For more detail on the targeted relief to capital and liquidity regulations provided by EGRRCPA, see the Capital and Stress Testing and Liquidity slides.
- See our visual memorandum here describing the key changes EGRRCPA 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

The following chart summarizes the state of play under the EPS proposed rules regarding asset-based regulatory thresholds applicable to U.S. BHCs that fall into the Categories defined in the previous page:

	Category IV	Category III	Category II	Category I – U.S. GSIBs
TLAC requirement				✓
GSIB surcharge				✓
Enhanced SLR				✓
Advanced approaches risk weights			✓	✓
AOCI recognized in capital			✓	✓
CCyB (if deployed)		✓	✓	✓
SLR		✓	✓	✓
Company-run DFAST		Every two years[1]	Annual	Annual
SCCL		✓[2]	✓[2]	✓
LCR		Full / Reduced[3]	Full	Full
Proposed NSFR		Full / Reduced[3]	Full	Full
Qualitative CCAR		✓	✓	✓
Proposed stress buffer requirements	✓[4]	✓	✓	✓
Quantitative CCAR	Streamlined annual[4]	Annual	Annual	Annual
Supervisory DFAST	Every two years	Annual	Annual	Annual
Internal liquidity stress testing	Quarterly	Monthly	Monthly	Monthly
Liquidity risk management	Slightly tailored	✓	✓	✓
Risk committee and risk management	✓	✓	✓	✓

1. A Category III firm would be required to submit internal stress test results to the Federal Reserve as part of its annual capital plan submission, but would be required to publicly disclose its company-run DFAST results only once every two years.
2. A Category II or III firm's aggregate net credit exposure to a single counterparty would be capped at 25% of tier 1 capital, which currently applies under the Federal Reserve's SCCL rule to U.S. BHCs that are not GSIBs and have ≥ $250B of total consolidated assets.
3. A reduced LCR and NSFR of between 70 and 85% of the relevant full requirement would apply to a Category III firm with < $75B of weighted STWF.
4. The Federal Reserve stated that its final stress buffer requirements rule and a forthcoming capital planning proposal will require a Category IV firm to submit a streamlined annual capital plan, but that the stress loss portion of a Category IV firm's stress buffer requirements would be updated every two years (to align with the two-year supervisory DFAST cycle for Category IV firms), whereas the planned distributions portion of the stress buffer requirements would be updated annually (based on the firm's annual capital plan).

Tailored Regulation

- **Federal Agencies Have Also Been Tailoring Their Regulations:**
  - Many existing regulations use one of the $10 billion and $50 billion asset thresholds established by Section 165 of Dodd-Frank. These regulations are not directly impacted by the revised asset thresholds under EGRRCPA, however, because they were not promulgated under the relevant provision of Dodd-Frank. During the October 2, 2018 Senate Banking Committee hearing, Vice Chairman for Supervision Quarles, Comptroller Otting and FDIC Chairman McWilliams agreed to submit written answers regarding whether their respective agencies will conform such other rules to the higher thresholds under EGRRCPA.
  - In September 2018, the OCC proposed a revision to its recovery planning guidance that would raise the asset threshold at which national banks, federal savings associations and federal branches of FBOs become subject to the OCC's recovery planning requirements from $50 billion to $250 billion in average total consolidated assets.
  - 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.

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 Chairman Powell and Vice Chairman for Supervision Quarles have signaled that the intention is not to weaken capital, liquidity or stress-testing requirements, but to strengthen and improve them by making them more transparent, efficient and simple.
  - **Capital:**
    - Simplification of Capital Rules for Non-Advanced Approaches Firms – proposed September 2017 (see slide 15)
    - Implementation of Stress Buffer Requirements (**SBR**) – proposed April 2018 (see slides 21 – 22)
    - Recalibration of enhanced SLR (**eSLR**) – proposed April 2018 (see slide 23)
    - Standardized Approach for Counterparty Credit Risk (**SA-CCR**) – proposed October 2018 (see slide 24)
    - Vice Chairman for Supervision Quarles has stated that the Federal Reserve will "inevitably" look at the G-SIB surcharge and that “it is relevant we try to ensure we have a level playing field internationally.”
    - Capital treatment of Current Expected Credit Losses methodology (**CECL**) – proposed 2018 (see slides 28 – 29)
  - **Stress Testing and Capital Planning (DFAST and CCAR):**
    - The Federal Reserve released a set of proposals in December 2017 aimed at increasing transparency of its stress testing (**DFAST**) and capital planning (**CCAR**) programs. In February 2019, the Federal Reserve issued an amended policy statement on the scenario design framework for supervisory stress testing, as well as a final notice regarding enhanced disclosure of the supervisory models used. The Federal Reserve is considering whether to publish its supervisory scenarios for comment.
    - The SBR proposal would also change certain CCAR and DFAST assumptions that could otherwise result in excessive stressed capital requirements for banking organizations that are subject to the DFAST and CCAR programs (see slide 21).

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 aggregate 15% of CET 1 threshold for the combined impact of the three categories of deduction items
    - 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
    - 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.)
    - Eliminate the restriction on the recognition of a subsidiary's surplus capital attributable to minority interests

Capital and Stress Testing

- **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**) • Interest Rate Risk in Banking Book (**IRBB**) • Revised Securitization Framework • Revised Treatment of Investment Funds • Standardized Measure for Operational Risk	• Basel Committee released finalized revisions to the Basel III capital standards in December 2017 • Revised assessment methodology published for G-SIBs • Capital Floors for Credit Risk • Unclear how Basel Committee capital floor standard will be implemented in the United States in light of the Collins Amendment, which effectively imposes 100% of standardized RWAs as a floor

- **Statutory Developments:** EGRRCPA makes the following changes to the **U.S. Basel III capital rules**:
  - **SLR for Custody Banks:** EGRRCPA 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 U.S. global custody banks will benefit from this provision because it is limited to banks that are "predominantly" engaged in custodial services.

Capital and Stress Testing

- **Community Bank Leverage Ratio / Off Ramp:** EGRRCPA directs the U.S. banking agencies to establish via rulemaking a community bank leverage ratio, and community 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.
- On February 8, 2019, the U.S. banking agencies proposed a rule that would simplify capital requirements for qualifying community banks by providing a community bank leverage ratio (**CBLR**) as an optional alternative to the U.S. Basel III capital rules.
  - Available for qualifying community banking organizations:
    - ≤ $10 billion in total consolidated assets
    - Off-balance sheet exposures, excluding derivatives other than credit derivatives and unconditionally correlative commitments, ≤ 25% of total consolidated assets
    - Trading assets / liabilities ≤ 5% of total consolidated assets
    - MSAs ≤ 25% of CBLR tangible equity
    - Temporary difference DTAs ≤ 25% of CBLR tangible equity
  - Minimum CBLR of 9% (tangible equity / average total consolidated assets)
    - Deemed to meet generally applicable U.S. Basel III capital requirements
    - Well-capitalized for prompt corrective action purposes
  - Simpler measure than U.S. Basel III risk-based capital calculations; additional qualifying capital instruments
  - Risk-insensitive because exposures are not risk-weighted

Capital and Stress Testing

- **Capital Treatment of Commercial Real Estate Exposures:**
  - On September 18, 2018, the U.S. banking agencies proposed a rule that would substantively replace the current definition of a High Volatility Commercial Real Estate (**HVCRE**) exposure in the capital rules with EGRRCPA's definition of a high volatility commercial real estate acquisition, development, or construction (**HVCRE ADC**) loan. This proposed rule would:
    - Provide a narrower definition of HVCRE exposures that must be risk weighted at 150% under the standardized approach
    - Only HVCRE ADC loans qualify for 150% risk weighting
      - Must "primarily" finance or refinance acquisition, development or construction of real property
      - Must have purpose of providing finance to acquire, develop or improve real property into income-producing property
      - Must be dependent on future income or sales proceeds from, or refinancing of, real property for repayment
    - Exempt projects meeting applicable maximum loan-to-value ratios and for which the borrower has contributed capital of at least 15% of the real property's "as completed" value for the life of the project
      - Appreciation in value of real property at time of contribution may be included in 15% contributed capital requirement
      - No restriction on distributing capital contributed in excess of 15% requirement
    - Exempt any loan made prior to January 1, 2015 – the date the original heightened risk weight for HVCRE exposures went into effect – from the new definition of an HVCRE exposure, as required by EGRRCPA
    - Apply the general 100% risk weight to non-HVCRE exposures, unless another lower or higher risk weight otherwise applies

Capital and Stress Testing

- Until this rule is finalized, the U.S. banking agencies' interagency statement announcing their interim position regarding EGRRCPA continues to apply. Under this interim position, banking organizations may either:
  - Risk weight at 150% only those exposures it believes meet the statutory definition of an HVCRE ADC loan, or
  - Continue to risk weight HVCRE exposures at 150% to the extent they meet the current regulatory definition

- EGRRCPA and the related tailoring proposal include the following changes to the **DFAST stress testing requirements**:
  - **Thresholds and Frequency of DFAST Company-Run Stress Tests:**
    - The Federal Reserve and other U.S. banking agencies have proposed rules that would tailor company-run and supervisory DFAST requirements for G-SIBs, BHCs and SLHCs based on the Category into which each firm falls:

	Category IV	Category III	Category II	Category I
Company-Run DFAST	Exempt	Every 2 years	Annual	Annual
Supervisory DFAST	Every 2 years	Annual	Annual	Annual

See slide 10 in the Tailored Regulation section above for a description of Categories I through IV, and slide 12 for a table describing the impact of the proposals on institutions in each of the categories.

- Although a Category III firm would be required to publicly disclose the results of its DFAST company-run stress tests only once every two years, it would still be required to submit internal stress test results annually to the Federal Reserve as part of its capital plan submission.

For more information on the revised G-SIB assessment methodology, visit the *FinReg* blog – "*Federal Banking Regulators Propose EGRRCPA-Conforming Amendments to Stress Testing Rules*" (January 22, 2019).

Capital and Stress Testing

- The U.S. banking agencies have also proposed changes to company-run DFAST requirements for banks and savings associations to:
  - Apply only to institutions with ≥ $250 billion in assets
  - Occur only every two years, beginning in 2020, unless the institution's parent holding company is required to conduct annual company-run stress tests

- EGRRCPA changes to the DFAST and CCAR requirements also include:
  - **Number of Dodd-Frank Act Stress Test Economic Scenarios:** EGRRCPA also reduces the required number of economic scenarios from three to two, eliminating the adverse scenario and leaving the baseline and severely adverse scenarios.
  - **Timing of CCAR and DFAST Threshold Changes:**
    - On October 31, the Federal Reserve and other U.S. banking agencies issued proposed rules that would adjust the thresholds applicable to BHCs' company-run and supervisory DFAST requirements.
      - BHCs with < $100 billion in total consolidated assets are exempt from both DFAST and CCAR for the 2019 cycle, as expected.
      - The proposed rules would remove the mid-cycle company-run stress test for all BHCs, including G-SIBs, effective in the 2020 cycle.
      - The proposed rules also stated that Federal Reserve and U.S. banking agencies, as appropriate, will issue proposed rules to align CCAR requirements for BHCs and company-run DFAST requirements for non-BHC companies, including banks, in the future.

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 (**SCB**) equal to a firm's peak-to-trough stress losses, on top of the G-SIB surcharge and any applicable countercyclical capital buffer.
    - The SBR proposal would incorporate four quarters of planned dividends based on a firm's baseline projections to the calibration of the SCB.
    - The SBR proposal would also modify several assumptions in the CCAR framework to better align them with a firm's expected actions under stress, including a constant rather than growing balance sheet.
  - **Modifications Coming**
    - As proposed, the SBR proposal would have been effective in time for the 2019 CCAR and DFAST cycle. In his November 9 speech at the Brookings Institution, however, Vice Chairman for Supervision Quarles said that the SBR proposal would be modified in response to "extensive and thoughtful" comments and delayed past the start of the 2019 CCAR and DFAST cycle.
      - Quarles stated that his foremost concern is the volatility of stress test results. He emphasized the need to strike a balance between ensuring that firms have sufficient notice of changes in their capital requirements and preserving the supervisory ability to adapt the stress tests to changing macroeconomic conditions and an evolving understanding of the salient risks.

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

- Quarles also previewed other modifications to the SBR proposal, including:
  - Modifying the market shock framework applicable to the six firms with the most significant trading activity to utilize more stress scenarios, rather than a single stress scenario;
  - Modifying the timing of the requirement to submit final capital distribution plans relative to the release of the supervisory stress test results, including the annual recalibration of firms' SCB requirements;
  - Alternatives to the dividend add-on component of the SCB calibration; and
  - Eliminating the stress leverage buffer so that risk-insensitive leverage requirements serve as a back-stop to risk-based requirements, as intended.

– **Multi-Step Approach:**
  - Quarles stated that the SBR would be finalized in two steps:
    - First, a final rule implementing "the basic framework" of the SCB expected in the near future.
    - Second, a re-proposal of "certain elements" of the SBR proposal, with these elements to be finalized at a later date.
  - Based on this timing, the first SCB would become effective starting with the 2020 CCAR and DFAST cycle.

– **Stop-Gap Modifications to 2019 CCAR and DFAST:** Quarles also stated that he would seek to modify certain elements of the 2019 CCAR quantitative assessment, given the delay in finalizing the SBR proposal and the pending proposed rules to tailor EPS in accordance with EGRRCPA.
  - In February 2019, the Federal Reserve announced that less-complex firms (assets ≥ $100 < 250 billion) will not be subject to stress testing during the 2019 cycle and that their capital distributions for this year will be based on the results from the 2018 stress tests.

Capital and Stress Testing

- The Federal Reserve will consider whether any of the SCB proposal's modified CCAR assumptions could be implemented for the 2019 CCAR cycle, including relaxing the assumption that firms' balance sheets would grow during the severely adverse stress scenario.

– **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 changes to the Basel III rules proposed by the Basel Committee on Banking Supervision.
- The proposal would also make corresponding changes to the calibration of the SLR components of the Total Loss Absorbing Capacity (**TLAC**) and long-term debt requirements for U.S. G-SIBs and invited comment on whether to recalibrate the TLAC SLR and long-term debt SLR to reflect more closely the capital refill framework and to more closely align the U.S. rules with international standards.
- Vice Chairman for Supervision Quarles stated in his April 2018 testimony to the House Financial Services Committee that the objective of the eSLR calibration is to make sure that the eSLR is not a primary binding capital measure.
- Quarles also stated that in that testimony that it would be appropriate to reconsider the proposed recalibration of the eSLR "to take account of the fact that certain [custody] banks would have had the denominator of the eSLR changed for them" under Section 402 of the EGRRCPA, which directs the U.S. banking agencies to exclude certain central bank deposits from the SLR denominator for certain custody banks.

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:**
  - **SA-CCR:** In October 2018, the Federal Reserve, the FDIC and the OCC released a joint proposed rule the would implement the standardized approach for counterparty credit risk (**SA-CCR**), a new standardized methodology for calculating the exposure amount for derivative contracts under the U.S. Basel III capital rules. The new SA-CCR methodology under the proposal would generally track the Basel Committee's version of SA-CCR finalized in 2014, which reflects a more risk sensitive approach than the existing current exposure method (**CEM**).
    - The proposal would require advanced approaches banking organizations to use SA-CCR to measure counterparty credit risk for derivatives, in lieu of CEM.
    - The proposal would permit non-advanced approaches banking organizations to use either SA-CCR or CEM to measure counterparty credit risk for derivatives.
    - The proposal would also make conforming changes incorporating the new SA-CCR methodology to other requirements related to derivative exposures, such as determining exposure amounts for cleared derivatives, calculating the risk-weighted asset amount for default fund contributions to CCPs, and measurements of off-balance sheet exposures related to derivatives under the SLR.
    - The proposal would also indirectly affect the measurement of exposure concentrations for purposes of the SCCL requirements.
    - The Commissioners of the CFTC released a comment letter on the proposed rule, arguing that without revisions to the proposed SA-CCR rule, clearing members will continue to limit the provisions of clearing services or exit the clearing business, causing the worrisome trend of clearing member consolidation to continue.
  - See slides 28 – 29 for a discussion of CECL.

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, 2018 speech that the Federal Reserve intends to propose a final rule in the near future.
- **Statutory Developments:** EGRRCPA makes the following changes to the **U.S. Basel III liquidity rules**:
  - **Treatment of Municipal Securities under the LCR:** As required by EGRRCPA, 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*" (Aug. 23, 2018).

TLAC

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

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

TLAC

- The Federal Reserve's and OCC's April 2018 proposal on the recalibration of eSLR would also make changes to the calibration of the SLR components of the TLAC and long-term debt requirements for U.S. G-SIBs, and invited comment on whether to recalibrate the TLAC SLR and long-term debt SLR to reflect more closely the capital refill framework and to more closely align the U.S. rules with international standards.
- The Treasury Department's December 2018 proposed regulations on the Base Erosion and Anti-Abuse Tax (**BEAT**) would create an exception from base erosion payment status for interest paid or accrued on internal TLAC securities issued by IHCs of non-U.S. G-SIBs as required under the Federal Reserve's TLAC rule. Final regulations are expected by June 2019.

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

CECL

- **General Outlook:** The Current Expected Credit Losses methodology accounting standard (**CECL**), will become effective for SEC-reporting companies for fiscal years beginning after December 15, 2019, but the financial sector is calling for implementation to be delayed.
- **CECL Overview:** The CECL accounting standard applies to all banks, savings associations, credit unions and financial institution holding companies, regardless of size, that file reports in U.S. GAAP.
  - CECL will generally accelerate the recognition of credit losses because it requires recognition of lifetime expected credit losses for financial assets measured at amortized cost upon originating or acquiring the asset.
  - Upon adopting CECL, companies will record a one-time adjustment to credit loss allowances at the beginning of the applicable fiscal year.
- **Regulatory Developments:**
  - On September 6, 2017, the Federal Reserve, FDIC, OCC and NCUA published their second set of FAQs on the adoption of CECL, which cover various technical aspects regarding implementing CECL.
  - On December 21, 2018, the Federal Reserve, FDIC and OCC adopted a final rule that provides BHCs and banks with the option to phase-in the Day 1 adverse regulatory capital effects of CECL over a period of three years. The final rule is effective April 1, 2019, and banking organizations that choose to adopt early CECL may elect to adopt the final rule as of the first quarter 2019.
    - The rule is intended to mitigate adverse impact of CECL on regulatory capital including:
      - Reduction in earnings or retained earnings
      - Increases in temporary difference DTAs that are included in risk-weighted assets or deducted from CET1 capital if they exceed deduction thresholds

CECL

- In the event of an M&A transaction, an acquirer would continue using its transitional amounts based on its calculation as of the CECL adoption date, and would **not** add any transitional amounts of seller

– On December 21, 2018, the Federal Reserve announced that it would not alter its existing modeling framework for supervisory stress testing for the 2019, 2020 and 2021 cycles, and that although BHCs subject to company-run stress tests as part of CCAR must incorporate CECL beginning in the 2020 cycle, the Federal Reserve will not issue supervisory findings on those firms' allowance estimations in CCAR through 2021.

- **Potential Methods of Change:** Legislative and Regulatory bodies continue to consider the potential effects of CECL:
  – On December 11, 2018, the House Financial Services Committee held a hearing with market participants to discuss the impact of CECL.
  – On December 18, 2018, 28 Republican House members wrote a letter urging FSOC to delay implementation of CECL and to conduct a comprehensive study of its effects on the banking industry and access to credit.
  – On December 19, 2018, the FSOC included CECL on the agenda for the closed portion of its meeting. Ahead of this meeting, financial industry trade groups, including the Bank Policy Institute (**BPI**) and the American Bankers Association, called for the FSOC to seek a delay in implementation of CECL until an impact study is performed.
  – On January 28, 2019, the Financial Accounting Standards Board, which issued CECL in 2016, held a public roundtable to discuss implementation issues related to CECL, including a proposal by regional bank representatives to bifurcate the credit loss estimates under CECL between balance sheet amounts and accumulated other comprehensive income.

Foreign Banking Organizations

- **General Outlook:** EGRRCPA provides regulatory relief to FBOs under certain asset thresholds. The Federal Reserve announced its intent to issue a proposal to tailor its regulations for foreign banks.
- **Statutory Developments:**
  - EGRRCPA increased the statutory threshold for most of the Federal Reserve's EPS to $250 billion in total consolidated assets.
  - As passed by Congress, EGRRCPA 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 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 in global total consolidated assets
- **Regulatory Developments:**
  - The Federal Reserve's inaugural Supervision and Regulation Report, published in November 2018, highlighted concerns about FBOs.
    - The report noted that, contrary to a general downward trend in outstanding supervisory findings at large financial institutions, MRAs and MRIAs have increased for large FBOs.
    - The report stated that FBOs continue to face challenges regarding compliance with EPS, including the IHC requirement and risk management and reporting systems requirements.
  - The proposed tailoring rules issued in October 2018 did not address FBOs, but the Federal Reserve stated that "[a] separate tailoring proposal affecting foreign banks will be released in the future." Vice Chairman for Supervision Quarles stated in his November 2018 testimony before the House Financial Services Committee that the proposal would be released early in 2019.

Foreign Banking Organizations

- Vice Chairman for Supervision Quarles stated in his October 2018 testimony before the Senate Banking Committee that the Federal Reserve is "not including any changes to the FBO regulatory scheme for FBOs with more than $250 billion in global assets as part of [its] implementation of tailoring mandated by [EGRRCPA]."
- 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 EGRRCPA.
- 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 < $100 billion to comply with the general EPS requirements or with certain reporting, disclosure and recordkeeping requirements.
- In the preamble to the SCCL final rule, the Federal Reserve noted that it interprets EGRRCPA to have "restrict[ed] the scope of application of most [EPS] . . . to . . . FBOs with $250 billion or more in total consolidated assets."
  - The SCCL 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 noted that the Federal Reserve may, through a separate rulemaking, apply the SCCL to FBOs and U.S. BHCs with ≥ $100 billion < $250 billion in global total consolidated assets.

Foreign Banking Organizations

- **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.

Foreign Banking Organizations

The following chart summarizes the Federal Reserve's current approach to implementing EGRRCPA 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

"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**). A proposal to codify the Federal Reserve's interpretations of "controlling influence" is expected in 2019.
- The proposed regulation is expected to address, and potentially liberalize, the circumstances in which a firm would **not** be deemed to exercise a controlling influence, including:
  - Non-voting equity a firm may own in addition to or instead of voting equity
  - Extent of representation on a board of directors, which is currently generally limited to one director
  - Extent of consent rights over extraordinary corporate transactions
  - Extent of business relationships with the other firm
- These expected changes could facilitate minority, non-controlling investments (1) in banking organizations and (2) by banking organizations in other companies.
- **Room for Improvement:**
  - In keeping with the broader regulatory agenda of the Federal Reserve under the current administration, we expect the proposed changes will make the process for control determinations more transparent, simpler to understand, easier to apply and more consistent with the rule of law.
  - The current definition of "control" under the BHC Act, and particularly the Federal Reserve's interpretations of "controlling influence," have created too much uncertainty in connection with investments in and by the banking sector.

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).

"Control" and "Controlling Influence"

- 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.
- The current control framework also conflicts with the Federal Reserve's efforts to be more transparent. Many control precedents are not public and many 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."

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).

Chapter 14: Financial Institutions Bankruptcy Reform

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

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

Living Wills

- **General Outlook:** A Notice of Proposed Rulemaking to revise the 165(d) rule, and an advance notice of proposed rulemaking (**ANPR**) to revise the IDI Plan rule, are expected in the coming months. No IDI Plan submissions will be required until a revised rule is issued.
- **Regulations**
  - The Federal Reserve and FDIC have stated that, pursuant to EGRRCPA, the Federal Reserve will determine which firms with more than $100 billion but less than $250 billion in total consolidated assets will be subject to the 165(d) living will requirement going forward. The agencies stated that the Federal Reserve will make this decision during 2019.
  - According to FDIC Chairman McWilliams, a Notice of Proposed Rulemaking to revise the 165(d) Plan rule, and an ANPR to revise the IDI Plan rule, will be released "in the coming months". McWilliams also stated that no IDI Plan submissions will be required until the new IDI Plan rule is issued.
    - Federal Reserve Board General Counsel Mark Van Der Weide stated in November 2018 that the 165(d) rule may be changed to (1) raise the threshold for covered firms to $250 billion, (2) move submissions to a two-year cycle, and (3) reduce the burden of living wills by more appropriately tailoring requirements.
    - Chairman McWilliams stated that the IDI Plan rule may be changed to (1) raise the threshold for covered firms, and (2) reduce the burden of the IDI Plan by appropriately tailoring requirements.
- **Guidance**
  - Proposed resolution plan guidance for FBOs may be released in the future.
  - Guidance on intra-group liquidity is expected in the future, although the timing on this proposed guidance is unclear.

For more information on living wills, please visit the *FinReg* blog – "*Feedback on Foreign Banks' July 2018 Resolution Plan Submissions – Key Takeaways*" (Dec. 28, 2018) and "*Resolution 2.0 – The Future of U.S. Resolution Planning for U.S. G-SIBs Starts to Come into Focus*" (Dec. 4, 2018).

Living Wills

- **Feedback**
  - Feedback on all IDI Plan submissions made on July 1, 2018 will eventually be released, although it is unclear if such guidance will be public or private.
- **Possible Legislation**
  - The Financial Institution Living Will Improvement Act, which passed the House in January 2018 with unanimous support and was included in other proposed omnibus legislation, would enshrine many changes to the living wills process in statute, including moving to a two-year submission cycle for Title I plans and requiring feedback on submissions within six months. The Act may be reintroduced in the new Congress as a standalone bill or as part of a broader legislative package given its previous bipartisan support.

For more information on living wills, please visit the *FinReg* blog – "*Feedback on Foreign Banks' July 2018 Resolution Plan Submissions – Key Takeaways*" (Dec. 28, 2018) and "*Resolution 2.0 – The Future of U.S. Resolution Planning for U.S. G-SIBs Starts to Come into Focus*" (Dec. 4, 2018).

Volcker Rule

- **General Outlook:** Changed by EGRRCPA; will be further changed by proposed amendments to regulations.
- **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.
  - On October 1, 2018, a group of seven Republican senators led by Senator Crapo wrote a letter to the five agencies and the Secretary of the Treasury supporting the proposed amendments and encouraging the agencies to add additional exclusions to the definition of covered fund for venture capital, other long-term investment and loan creation vehicles.
  - Statutory amendments in EGRRCPA 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.

Volcker Rule

- 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.**
- **EGRRCPA:**
  - 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
  - On December 18, the agencies released a proposed rule that would amend the Volcker Rule regulations to implement the community bank exemption pursuant to EGRRCPA, without any additional requirements.
    - The proposed rule would also modify the name-sharing restriction for covered funds pursuant to EGRRCPA by permitting a covered fund to share the same or similar name as a an investment adviser to the fund if (1) the investment adviser is not a bank, BHC or company that controls bank, (2) the investment advisor does not share the same or similar name with any such entity, and (3) the name does not contain the word "bank."

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

Community Reinvestment Act

- **Change is Coming:** Leadership at the Treasury Department, OCC, FDIC and Federal Reserve have strongly signaled support for revising the Community Reinvestment Act (**CRA**) regulatory framework.
  - Based on public statements, however, there is not yet consensus on how to accomplish that reform.

Treasury	OCC	FDIC	Federal Reserve
• 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 OCC, without sign-on from the Federal Reserve or the FDIC, 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. – 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 43 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. – Comment letters reflected: • Increased pressure to expand CRA to credit unions and other nonbank financial firms • Strong disapproval from State Attorney Generals	• Indicating a preference for a moderate approach to CRA reform, Chairman McWilliams has defended the importance of branches in low- and moderate-income communities to the extent that consumers rely on branches in these areas more than they rely on digital services. • In a nod to cooperation, the FDIC has indicated that it will join in a proposed rulemaking and downplayed the significance of the OCC acting on its own.	• Vice Chairman for Supervision Quarles agrees with FDIC Chairman McWilliams that, despite the evolution of the financial system, physical branches of banks still play an important role in certain communities and CRA reform must take this into account. • The Federal Reserve will be holding a series of roundtables across the country on the CRA and plans to make public its findings from the initiative. • The Federal Reserve, although it did not join in the ANPR, will be reading the comment letters in anticipation of a joint proposal.

For more information on expected future CRA developments, see *What Comes Next with Respect to CRA Reform*, Business Law Today, ABA Business Law Section (Dec. 11, 2018).

Community Reinvestment Act

- Providing banks with CRA credit for different types of loan products and expanding assessment areas for communities that fall outside of a bank's physical branch network generally have stronger support than the single metric. However, Democratic leaders have cautioned against expanding assessment areas so broadly as to make it easier for banks to pass their CRA exams.
- **Democratic Points of View:**
  - Federal Reserve Governor Brainard spoke extensively about the CRA in a number of her 2018 speeches; while broadly agreeing with the need for change, she has indicated a desire to moderately adjust the current regulatory framework as opposed to following the transformational, metric-based approach outlined by the OCC.
    - At odds with Comptroller Otting's vision, Governor Brainard has expressed support for tailored regulation based on bank size and business model.
  - In a letter to the Federal Reserve, OCC and FDIC, 16 Democratic senators led by Senator Warner outlined:
    - Support for Treasury's recommendation to update geographic assessment areas
    - Opposition to the adoption of OCC 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
  - Further, Senator Warren has:
    - Introduced a bill that would extend the applicability of CRA requirements beyond FDIC-insured banks to credit unions and nonbank mortgage originators and increase the severity of penalties for CRA violations
    - Asserted that the OCC's ANPR proposals indicate a desire to weaken the CRA, which Comptroller Otting argued is inaccurate
    - In a letter to Comptroller Otting, nine Democratic senators led by Senator Brown expressed concern about 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.

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.

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

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 addition, the banking agencies are taking note that an AML framework for virtual currencies has yet to be put in place, and will need to be developed as the technology evolves.
  - AML/BSA compliance has also been identified as a supervisory priority for state member banks and FBOs in the Supervision and Regulation Report issued by the Federal Reserve in November.

For more information, please visit the *FinReg* blog – "*U.S. Regulators Announce BSA/AML Enforcement Actions Against U.S. Broker-Dealers*" (Jan. 2, 2019).

Anti-Money Laundering

- **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 a November 2018 Senate Banking Committee hearing, the director of FinCEN emphasized the critical nature of BSA/AML data in FinCEN investigations and the importance of closing the gap that allows criminals to launder money through legal entities.
  - The OCC is undertaking a systematic review of SAR and CTR requirements, in order better tailor their content and make the data more useful for law enforcement.

For more information, please visit the *FinReg* blog – "*U.S. Regulators Announce BSA/AML Enforcement Actions Against U.S. Broker-Dealers*" (Jan. 2, 2019).

Bank Secrecy Act

- **General Outlook:** Changes to the Bank Secrecy Act (BSA) and other AML rules are being seriously discussed, and Comptroller Otting has made it clear that reform in this area is one of his top priorities. Legislative change is uncertain.
  - An October 2018 BPI empirical study of the U.S. AML/CFT regime, *Getting to Effectiveness – Report on U.S. Financial Institutions Resources Devoted to BSA/AML & Sanctions Compliance*, found that financial institutions have invested approximately $2.4 billion on AML/CFT compliance, and in 2017, reviewed 16 million alerts leading to the filing of 640,000 SARs and 5.2 million CTRs.
    - In addition, only 4% of SARs and 0.44% of CTRs filed by financial institutions are deemed useful by law enforcement.
    - A central recommendation of the study is that Treasury should have a more prominent role in coordinating AML/CFT policy and examinations, as well as lead a multi-agency review of the AML/CFT regime in order to prioritize the reporting of activities that provide effective, useful information to law enforcement.
- **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, 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

For more information, please visit the *FinReg* blog – "*FinCEN and Banking Regulators Issue Joint Statement on Innovation in BSA/AML Compliance*" (Dec.10, 2018) and "*One Small Step for AML: Federal Banking Regulators Issue Joint Statement on BSA/AML Resource Sharing*" (Oct. 8, 2018).

Bank Secrecy Act

- 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

– On October 3, 2018, the OCC, Federal Reserve, FDIC, NCUA, and FinCEN issued an interagency statement to address ways in which small banks and credit unions can collaborate in order to share resources to manage their BSA/AML obligations.

– On December 3, 2018, the OCC, Federal Reserve, FDIC, NCUA and FinCEN issued an interagency statement to encourage technological innovation in developing new, and/or augmenting current, AML/BSA compliance programs.

For more information, please visit the *FinReg* blog – "*FinCEN and Banking Regulators Issue Joint Statement on Innovation in BSA/AML Compliance*" (Dec. 10, 2018) and "*One Small Step for AML: Federal Banking Regulators Issue Joint Statement on BSA/AML Resource Sharing*" (Oct. 8, 2018).

OFAC Sanctions

- **General Outlook:** Under the Trump Administration, there have been significant developments with respect to sanctions against Iran, Russia, North Korea, Cuba, and Venezuela. 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 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 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.
  - As of November 5, 2018, all U.S. sanctions (both primary and secondary) that had been waived or lifted under the JCPOA have been reimposed and are in full effect. The State Department granted "significant reduction" exceptions to eight countries, allowing them to continue – at least temporarily – importing Iranian oil and engaging in a limited range of transactions with certain Iranian banks.

For more information on developments regarding economic sanctions, please see our client memorandum – "*U.S. Government Fully Re-Imposes Iran Sanctions, Announces 'Unprecedented' Sanctions Effort as it Moves on from the JCPOA*" (Nov. 6, 2018), and visit the *FinReg* blog's Economic Sanctions section here, including – "*As Sanctions 'Snap-Back' Approaches, FinCEN Advisory Emphasizes Risks to the U.S. and International Financial Systems Posed by Iran*" (Oct. 15, 2018), "*OFAC Enforcement Highlights Risk of Indirect Sanctions Violations, Importance of Acting on 'Red Flags'*" (Oct. 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. OFAC has subsequently taken action to ameliorate some of the effects of these sanctions on U.S. persons, including by announcing its imminent intent (despite Congressional opposition) to lift sanctions against three companies associated with Oleg Deripaska following his partial divestment from these entities.
  - On August 8, 2018, the Trump Administration announced that they were imposing sanctions against Russia under the Chemical and Biological Weapons Control and Warfare Elimination Act of 1991. The first round of sanctions includes additional restrictions on the export of dual-use technologies and took effect on August 27. On November 6, the State Department informed Congress that they could not certify Russia's compliance with the Act, paving the way for potential new sanctions.

For more information on developments regarding economic sanctions, please visit the *FinReg* blog's Economic Sanctions section here, including – "*OFAC Announces Intent to Delist Rusal and Other Entities Owned by Sanctioned Oligarch Deripaska*" (Dec. 21, 2018) and "*Russia Sanctions Updates*" (Sept. 24, 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 CFPB 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.

OFAC Sanctions

- **Venezuela**
  - On August 24, 2017, the Administration issued a new Executive Order imposing financial sanctions on the Government of Venezuela designed to deny funding to the Maduro "dictatorship."
  - The Executive Order prohibits U.S. persons and persons within the U.S. from engaging in transactions related to, providing financing for, or otherwise dealing in:
    - New debt with a maturity of greater than 90 days of Petroleos de Venezuela, S.A. (**PdVSA**), which is Venezuela's state-owned oil company
    - New debt with a maturity of greater than 30 days, or new equity, of the Government of Venezuela (other than PdVSA)
    - Bonds issued by the Government of Venezuela prior to August 25, 2017
    - Dividend payments or other distributions of profits to the Government of Venezuela from any entity owned or controlled, directly or indirectly, by the Government of Venezuela
    - Purchasing, directly or indirectly, any securities from the Government of Venezuela other than securities qualifying as new debt with a maturity of less than or equal to 90 days for PdVSA or 30 days for the rest of the Government of Venezuela.
  - In addition to the Executive Order, OFAC issued four related general licenses authorizing certain transactions such as those to wind down existing contracts and those for dealings in certain bonds.
  - Another Executive Order followed on March 19, 2018 which banned U.S. transactions in the digital currencies established by the Government of Venezuela, the "petro" and the "petro-gold."
  - On January 28, 2019, the Administration sanctioned PdVSA. The designation of PdVSA blocked all property and interests in property of PdVSA in the U.S. or in the control of U.S. persons.
    - The sanctions also apply to entities that are 50% or more owned, either directly or indirectly, by PdVSA, including its U.S. subsidiary CITGO Holding, Inc.

For more information on developments regarding economic sanctions, please visit the *FinReg* blog's Economic Sanctions section *here*, including – "*Issuance of Venezuela-related Executive Order and Associated General Licenses*" (Aug. 25, 2017), "*Trump Administration Imposes Sanctions Targeting Controversial Venezuelan Digital Currency*" (Mar. 20, 2018) and "*OFAC Designates PdVSA*" (Jan. 29, 2019).

Derivatives

- **General Outlook:** Incremental changes to the OTC derivatives regime have occurred and are likely to continue to occur incrementally 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. President Trump has nominated Heath Tarbert, a senior Treasury Department official, to replace Chairman Giancarlo.
- **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

For more information, please see the *FinReg* blog – "*CFTC Adopts Final Rule Amendments Simplifying CCO Duties and Annual Report Rules for FCMs, Swap Dealers and MSPs*" (Aug. 29, 2018).

Derivatives

- **CFTC Examination Priorities**
  - For the first time in the agency's history, the CFTC published examination priorities for the entities it regulates for 2019. Of note, the CFTC plans to focus "on more frequent and prompt examinations and emerging trends, products, and technologies." In addition, the first priority listed for the Division of Market Oversight is "cryptocurrency surveillance practices."
- **Final Rulemakings:** As part of its Project KISS program, in August 2018 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.
  - The CFTC's $8 billion swap dealer *de minimis* registration threshold has been made permanent.
- **Rule Proposals:** The CFTC has proposed significant rulemakings in a number of areas, including:
  - In November 2018, the CFTC proposed amendments to the rules governing swap execution facilities (**SEFs**), including changes that would expand the scope of products subject to the trade execution requirement, permit trade execution by any means available to the SEF and broaden the types of entities required to be registered as SEFs. The comment deadline has been extended until March 15, 2019.
  - In October 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 registration and compliance requirements for commodity pool operators (**CPOs**) and commodity trading advisors by codifying certain staff letters and advisories that, among other things, streamline registration and compliance requirements for CPOs that operate in multiple jurisdictions, prohibit statutorily disqualified persons from operating exempt pools and provide registration relief for qualifying family offices and investment advisers of business development companies.

For more information, please see the *FinReg* blog – "*CFTC Adopts Final Rule Amendments Simplifying CCO Duties and Annual Report Rules for FCMs, Swap Dealers and MSPs*" (Aug. 29, 2018).

Derivatives

- As part of the Project KISS initiative, 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.

- **SEC Rulemaking:** The SEC reopened the comment period and requested additional comments in October 2018 for previously proposed rules relating to capital, margin, and segregation requirements for security-based swap dealers (**SBSDs**), major security-based swap participants (**MSBSPs**) and, in some cases, broker-dealers.
  - Adoption of these rules is an important predicate to the implementation of other security-based swap rules.
  - The date on which SBSDs will be required to register with the SEC and comply with various requirements, including business conduct standards and trade acknowledgement and verification requirements:
    - Will not occur until at least six months after the Federal Register publication of the final capital, margin, and segregation rules
    - Is also contingent upon the finalization of additional rules, including the occurrence of the compliance date for final rules regarding recordkeeping and financial reporting requirements for SBSDs and MSBSPs
  - The SEC has proposed rules that would require the application of risk mitigation techniques to portfolios of uncleared security-based swaps, including periodic portfolio reconciliation, portfolio compression exercises and relationship documentation.
  - The SEC also adopted Rule of Practice 194, which establishes a process for registered SBSDs to apply for relief from statutory disqualification.

For more information, please see the *FinReg* blog – "*SEC Reopens Comment Period for Security-Based Swap Capital, Margin and Segregation Rules*" (Oct. 12, 2018).

Derivatives

- **CFTC / SEC Coordination:** 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.
- **International Cooperation and Cross-Border Rules:** Chairman Giancarlo issued a white paper entitled "Cross-Border Swaps Regulation Version 2.0: A Risk Based Approach with Deference to Comparable Non-U.S. Regulation," setting out guiding principles for the CFTC in interpreting its statutory authority to regulate cross-border swaps activities. The white paper recommends five specific areas for reform:
  - Expansion of the use of the CFTC's exemptive authority for non-U.S. CCPs that are subject to comparable regulation in their home country and do not pose substantial risk to the U.S. financial system
  - Ending the bifurcation of the global swaps markets into separate U.S. person and non-U.S. person marketplaces by exempting non-U.S. trading venues in jurisdictions with comparable G20 swaps reforms from having to register with the CFTC as a swap execution facility
  - Requiring registration of non-U.S. swap dealers whose activity poses a "direct and significant" risk to the U.S. financial system and showing appropriate deference to non-U.S. regulatory regimes with comparable requirements for entities engaged in swap dealing activities

For more information, please see the *FinReg* blog – "*SEC Reopens Comment Period for Security-Based Swap Capital, Margin and Segregation Rules*" (Oct. 12, 2018).

Derivatives

- Adopting an approach that permits non-U.S. persons to rely on substituted compliance with respect to swap clearing and trade execution requirements in comparable jurisdictions and apply those requirements in non-comparable jurisdictions with a "direct and significant" effect on the United States
- Taking a territorial approach to U.S. swaps trading activity, including trades that are "arranged, negotiated, or executed" within the U.S. by personnel or agents of such non-U.S. persons, where non-incidental swaps trading activity in the U.S. should be subject to U.S. swaps trading rules with some activity subject to CFTC rules

- In a speech on October 17, 2018, Chairman Giancarlo described his discussions with EU regulatory authorities, in which he asked them to reconsider plans to expand their regulation of counterparty clearinghouses, including U.S. counterparty clearinghouses operating in the EU.
- In a speech on January 25, 2019, Chairman Giancarlo stated that, upon the conclusion of the federal government shutdown, he would direct CFTC staff to prepare new cross-border rule proposals that will replace the CFTC's 2013 cross-border guidance and 2016 proposed cross-border rules.
- The CFTC, Bank of England and Financial Conduct Authority have released a joint statement on derivatives trading and clearing post-Brexit in which the CFTC stated that it will take steps to ensure that existing regulatory relief granted by the CFTC for EU firms will continue to apply to UK firms upon the UK's withdrawal from the EU.

For more information, please visit the *FinReg* blog – "*Chairman Giancarlo's White Paper Outlines Specific Recommendations to Cross-Border Swaps Regulation*" (Oct. 12, 2018).

Brokered Deposits

- **General Outlook:** The FDIC has published an ANPR to undertake a "comprehensive review" of brokered deposits and interest rate caps for banks that are less than well capitalized.
- The ANPR is not a specific proposal, but seeks comment on issues including:
  - Specific or other technology changes that the FDIC should take into account in its review
  - Current treatment of certain deposits as brokered or not brokered
  - Ways for the FDIC to provide sufficient clarity regarding who is or is not a deposit broker and what is or is not a brokered deposit
  - Any necessary statutory changes
- Modernization of the approach to brokered deposits could potentially result certain deposits, including certain sweep deposits and deposits in which an affiliate plays a role, no longer being treated as brokered deposits.

Regulation Best Interest

- 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.
- **General Outlook:** Chairman Clayton has signaled Regulation Best Interest a top priority and therefore likely to be finalized sometime this summer, but the threat of litigation looms and some states are forging ahead with their own (often more stringent) standards.
  - In New York, a proposed bill would require non-fiduciary advisors to provide a "plain-language" disclosure stating that they are not requiring to act in their clients' best interests.
- Congressional Democrats have expressed opposition to the proposal and called for a higher, fiduciary standard that they believe to be consistent with the requirements of Dodd-Frank.
  - In a letter written by Representative Waters and Senators Brown and Murray, thirty-five Congressional Democrats urged 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."
  - The SEC's Director of the Division of Investment Management has stated that there is no gap between what Dodd-Frank proposed and what the SEC is effectuating with Regulation Best Interest, because the core principles of both are the same.
  - However, the SEC Investor Advisory Committee has stated the proposal can be strengthened by explicitly characterizing the best interest standard as a fiduciary duty—although it should be made clear that what specific obligations flow from the fiduciary duty will differ according to different business models.

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: 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.
  - 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
- **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.

Board Interlocks

- **General Outlook:** The Depository Institutions Management Interlocks Act (**DIMIA**), implemented by Regulation L, contains a "major assets" prohibition that prevents a management official of a depository organization with > $2.5 billion in total assets (or any affiliate thereof) from serving as a management official of an unaffiliated depository organization with > $1.5 billion in total assets (or any affiliate thereof)
- The Federal Reserve, FDIC and OCC recently published a proposal to **raise the "major assets" thresholds** to only apply to depository organizations with **≥ $10 billion in total assets**
  - The thresholds have not been revised since first enacted in 1996
  - A depository organization would still have the ability to seek an exemption from the revised threshold
  - No changes would be made to the geographically-based community or metropolitan statistical area prohibitions, which continue to apply to all depository organizations regardless of size
- The banking agencies have also asked for comment on ways to **update** the revised thresholds on a **go-forward basis**:

Approach	Description
#1	Adjust the thresholds to maintain the same total number of banking institutions subject to the prohibition as when DIMIA was first enacted
#2	Multiply the thresholds by match the proportion of growth in total assets since 1996 (estimated to be 3.5x)
#3	Adjust the thresholds for inflation

For more information on the interlocks proposal, please visit the *FinReg* blog – *"Board Interlocks and Investment in the Banking Sector"* (February 5, 2019).

Board Interlocks

- In the digital era, the prohibition on interlocks, especially at the director level, can stand in the way of investment into the banking sector
  - DIMIA applies to both management and director interlocks, but as a practical matter is typically of concern for directors
  - The exemption process typically involves obtaining approval from more than one regulator and significant delay
- Raising the thresholds is one method to encourage more investment in fintech business models that choose a banking charter and, when combined with the Federal Reserve's expected modernization of the control rules, may encourage more innovation.

Cannabis-Related Banking

- **General Outlook:** The direction of the federal regulatory and enforcement framework for financial institutions providing services to U.S. cannabis-related businesses has been uncertain, and providing direct banking services to such businesses has therefore been considered too perilous by most large institutions. While legalization of cannabis remains a distant prospect for a divided Congress in 2019, federal relief for related banking services has been garnering bipartisan support, and the resignation of Attorney General Sessions may make a political or regulatory compromise more possible.
  - As Canada and more states legalize cannabis, even those banks avoiding the sector will face increased diligence burdens. The need for legislative relief has been taken up by members of Congress and regulatory leaders of both political parties, including:
    - Representative Waters, who stated in November 2018 that "it's inevitable we are going to have to talk about" this issue
    - Chairman Powell, who stated in February 2019 that "financial institutions—and their regulators and supervisors—are in a very difficult position here with marijuana being illegal under federal law and legal under a growing number of state laws…It would be nice to have clarity on that supervisory relationship."
    - Comptroller Otting, who stated in January 2019 that "Congress is going to have to act at the national level to legalize marijuana if they want those entities involved in that business to utilize the U.S. banking system"
- **The SAFE Banking Act**
  - On February 13, 2019, a subcommittee of the House Financial Services Committee convened a hearing about challenges for cannabis-related banking. Representative Perlmutter introduced a discussion draft of the Secure and Fair Enforcement Banking Act of 2019 (**SAFE Banking Act**) at the hearing.

Cannabis-Related Banking

- Its previous iterations in the House and Senate, also targeted at providing clarity to banks, had attracted bipartisan support:
  - The Secure and Fair Enforcement Banking Act of 2017, introduced by Representative Perlmutter in April 2017, had 95 cosponsors, including 12 Republicans, by the end of the last Congress.
  - The Senate version of the Secure and Fair Enforcement Banking Act of 2017, introduced by Senator Merkley in May 2017 and reintroduced as a proposed amendment to EGRRCPA in March 2018, had 20 cosponsors, including four Republicans, by the end of the last Congress.
- The SAFE Banking Act would 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
- The bill goes further than previous iterations by providing that proceeds from a transaction conducted by a cannabis-related legitimate business shall not be considered proceeds from an unlawful activity under the Money Laundering Control Act or any other Federal law solely because the transaction was conducted by a cannabis-related legitimate business.

Cannabis-Related Banking

- The bill provides 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 bill defines "cannabis-related legitimate business" to include providers of financial services related to cannabis (e.g., retirement plans, ETFs), and providers of other business services relating to cannabis (e.g., real property, legal).

- **The STATES Act**
  - The bipartisan Strengthening the Tenth Amendment Through Entrusting States Act (**STATES Act**) was introduced by Senators Warren and Gardner in June 2018, and reintroduced as a proposed amendment to a criminal justice reform bill in December 2018. The STATES Act would clarify 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 had 10 cosponsors, including five Republicans, by the end of the last Congress.
  - The STATES Act would also protect the banking sector by providing that:
    - The proceeds of any marijuana transaction conducted in compliance with state law and the STATES Act 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, 2018, 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 accompanying licensing manual supplement stated that such special purpose national banks "would engage in one or more of the core banking activities of paying checks or lending money, but would not take deposits and would not be insured by the [FDIC]…Fintech companies that…plan to take insured deposits…should apply for a full-service national bank charter."
    - The release of the OCC's final policy statement and accompanying licensing manual supplement was quickly followed by criticism from the NYDFS and the Conference of State Bank Supervisors (**CSBS**), 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, 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. The CSBS also filed a suit against the OCC, reasserting its previous policy concerns and legal objections.
    - The OCC's Chief Innovation Officer, Beth Knickerbocker, confirmed that the OCC had not received any applications for fintech charters as of October 16, 2018, but Comptroller Otting said on October 17, 2018 that the OCC would be able to approve or deny charters for fintech companies by the middle of 2019.

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).

Fed Faster Payments

- **General Outlook:** The Federal Reserve Faster Payments initiative is caught in the middle of a stakeholder battle between The Clearing House on one side and smaller banks and fintechs on the other.
- **Federal Reserve Faster Payments Proposal:**
  - In October 2018, the Federal Reserve released a request for comment on the actions the Federal Reserve could take to support faster payments in the United States. It proposed two actions:
    - A Federal Reserve-developed service for real-time interbank settlement of faster payments 24x7x365
    - A liquidity management tool that would enable transfers between Federal Reserve accounts on a 24x7x365 basis to support real-time interbank settlement of faster payments, regardless of whether those services are provided by the private sector or the Federal Reserve Banks
  - Comments on the proposal revealed three camps:
    - Larger financial institutions are in favor of the Federal Reserve developing a liquidity management tool but against the Federal Reserve developing its own real-time interbank 24x7x365 settlement system.
      - Concerns are around interoperability of the Federal Reserve's system with the current real-time settlement system operated by The Clearing House, unnecessary competition between the Federal Reserve and the private sector, and duplicative costs.
    - Community banks and credit unions want a clear decision made by the Federal Reserve on its involvement and are in favor of the Federal Reserve developing a real-time interbank settlement system.
      - Smaller institutions see a strong role for the Federal Reserve in this space as reducing the need for small institutions to give larger ones their money and customer data.
    - Fintechs and general corporates, such as Amazon, Walmart, and Google, are in favor of the Federal Reserve developing a real-time interbank settlement system and are in favor of this service being extended to non-bank providers.
  - The Federal Reserve has not indicated whether it will move forward with either proposed action.

Appendix:
Executive Order and Treasury Reports

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Executive Order and Treasury Reports

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*	October 2017
• *A Financial System that Creates Economic Opportunities: Asset Management and Insurance*	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

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