Davis Polk

Financial Services Regulatory Reform

WINTER FORECAST EDITION

January 26, 2023

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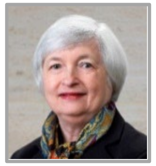
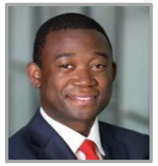
These slides set forth our views on the general outlook for key areas of policy development that are likely to affect the financial services industry. They will be updated from time to time.

Financial regulatory leadership as of January 26, 2023

Treasury


Secretary Yellen


Deputy Secretary Adeyemo

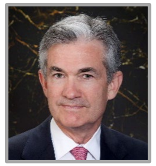

Under Secretary for Domestic Finance Liang


Under Secretary for Terrorism and Financial Intelligence Nelson


Under Secretary for International Affairs Shambaugh


Assistant Secretary for Financial Institutions Steele

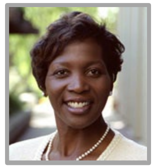
Federal Reserve


Chair Powell


Vice Chair Brainard


Vice Chair for Supervision Barr


Governor Bowman

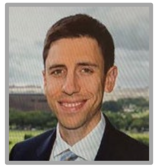

Governor Cook


Governor Jefferson


Governor Waller

FDIC


Chairman Gruenberg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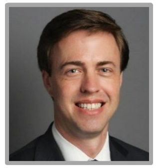
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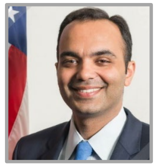
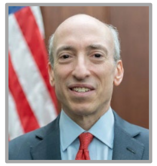

CFPB Director Chopra


Acting Comptroller Hsu

SEC


Chair Gensler

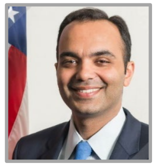

Commissioner Crenshaw


Commissioner Lizárraga


Commissioner Peirce


Commissioner Uyeda

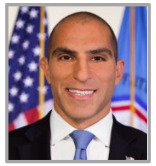
CFPB


CFPB Director Chopra

OCC

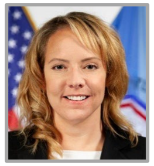

Acting Comptroller Hsu

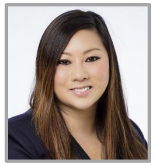
CFTC


Chairman Behnam


Commissioner Goldsmith Romero


Commissioner Johnson


Commissioner Mersinger


Commissioner Pham

Federal Reserve regulatory updates

General outlook: The Federal Reserve has indicated that it is moving forward with a regulatory agenda in both established and emerging regulatory areas. The November 2022 Supervision and Regulation Report focused on then-newly installed Vice Chair for Supervision Barr's near-term priorities, citing the agenda he had previously set out in a September 2022 speech, which had emphasized the Federal Reserve's complementary goals of promoting a "safer" and "fairer" financial system.

- Among other items, these priorities include:
  - Capital requirements, which Barr confirmed should be calibrated to the size and risk profile of a bank (this was reiterated in his remarks on December 1, 2022).
  - Resolution planning for financial institutions, including for the largest regional banks
  - Bank merger policy review
  - Stablecoins, for which Barr advocated congressional action, and risks related to crypto activities
  - Operational resilience in the face of challenges from disruptive events
- Barr has generally emphasized that is supportive of continuing to tailor rules to banks based on their size and risk profile. In Barr's September 2022 speech, he noted that "[a]s firms increase in systemic importance," regulations, particularly those related to capital, should be "designed to require firms to internalize the costs that their potential failure would impose on the… financial system. This means that firms face higher costs through more stringent regulations as they grow in complexity, size, and interconnectedness. And rightly, that community banks face simpler regulations."

Federal Reserve regulatory updates

- Later in September 2022, Governor Bowman delivered a speech in response to Barr's speech earlier that month. Although she stated she is "looking forward to "working with [Barr] on the dual goals of making the financial system safer and fairer," she warned against the overregulation of banks, especially the largest banks, and cautioned that "we should ensure that any further changes yield significant improvement to safety and soundness at reasonable cost."
  - Bowman also particularly cautioned against the use of stress tests that lead to overly volatile capital requirements.
- **Resolvability:** The Federal Reserve's unanimous approval order for a January 2023 bank acquisition hinted at an increased focus on resolvability of the acquirer in large bank M&A, which was also echoed in Vice Chair Brainard's accompanying statement. In that statement, Brainard expressed concern about the increase in concentration in the banking industry and implied that the Federal Reserve's recent Advanced Notice of Proposed Rulemaking (ANPR) on resolution planning by large regional banks factored into her vote for approval. She had issued an identical statement in connection with an October 2022 transaction approval order.
- **Regulatory refresh:** At an American Bar Association panel on January 7, 2023, Federal Reserve General Counsel Van Der Weide indicated, as in the same panel a year earlier, that Board Staff is still working on updating existing regulations, including Regulations Y, K, H, O and W, that have not been refreshed in over 20 years. However, he pulled back from the optimism expressed the prior year, stating only that staff would make "substantial progress" this year. Except for proposed rulemaking or longer term actions of certain elements of Regulation H and Y, these regulations were notably absent from the Fall 2022 Unified Regulatory Agenda.

Too-big-to-manage

- **Tone at the top at the OCC:** Acting Comptroller Hsu's January 17, 2023 remarks made clear that he believes that some banking organizations can become too big or complex to manage properly (TBTM). He called out "control failures, risk management breakdowns, and negative surprises [that] occur too frequently," not because management is weak, but because "effective management is not infinitely scalable." He stated that "detecting, preventing, and addressing TBTM risks will increasingly become an imperative for both banks and bank regulators."
- Hsu described a four-level escalation framework for the detection, prevention and remediation of TBTM risks:
  - At the first level are one or more matters requiring attention, or MRAs/MRIAs.
  - The second level involves a consent order.
  - The third level would be some combination of growth caps, capital action restrictions or business activity limits.
  - The fourth and final level following failure to remediate would be "simplification via divestiture," or "breaking up the bank."
- Hsu additionally focused on the value of detection and prevention, advising banks to investigate whether a weakness in one area of their operations may have permeated elsewhere.
- He stated that the OCC is "considering steps to provide greater transparency and predictability into the escalation framework just discussed," which we read to imply that there may be guidance, which presumably will be subject to notice and comment. TBTM was not on the OCC's Fall 2022 Unified Regulatory Agenda released in January 2023.
- Hsu also stated that he would welcome the opportunity to collaborate with the other bank regulators on TBTM risks.

Latest on climate

General outlook: The banking regulators are strongly signaling that their role in climate change is a narrow one. While the SEC continues to plow ahead with its long delayed and controversial climate disclosure rule, the scope of the rule continues to be hotly debated and it is unclear what the final version will include.

- In a January 2023 speech, Chair Powell stated that "without explicit legislation, it would be inappropriate for [the Federal Reserve] to use [its] monetary policy or supervisory tools to promote a greener economy or to achieve other climate-based goals. [The Federal Reserve is] not, and will not be, a 'climate policymaker.'"
- At a November 2022 Senate Banking Committee (SBC) hearing, Acting Comptroller Hsu stated, "It is not our role to tell bankers what customers or legal businesses they may or may not have as customers. We do not pick winners or losers. Rather, we are committed to staying in our safety and soundness lane, which means focusing on banks' risk management of climate-related financial risks, not on setting industrial policy."
- Similarly, for a January 2023 bank acquisition approval, the Federal Reserve's and OCC's approval orders acknowledged the submission of public comments on the parties' funding to fossil-fuel companies, but did not probe those concerns further. Instead, the Federal Reserve's order clarified that those concerns did not fall within its statutory scope of review for the application.

Latest on climate

Pilot climate scenario analysis: The Federal Reserve in January 2023 released instructions regarding its pilot climate scenario analysis exercise with six of the largest U.S. banks. The instructions state that the exercise "does not have consequences for bank capital or supervisory implications."

- The utility of similar types of exercises is not uncontested, with the outgoing Secretary General of the Financial Stability Board (FSB) stating that a "market-based solution," ideally a global carbon tax, would be more effective than these types of "very expensive planning" exercises.
- Accompanying the release, Vice Chair for Supervision Barr noted that the Federal Reserve has "narrow, but important, responsibilities regarding climate-related financial risks."

Climate-related financial risk: Each of the OCC, FDIC and Federal Reserve has released largely similar draft principles for climate-related risk management for public comment. The FSB has also issued similar draft principles. None of these have been especially controversial as they essentially mimic what well-run banking organizations are already doing today.

- The most recent of these to be issued, the Federal Reserve's release, stated that the Federal Reserve "would coordinate with the OCC and the FDIC in issuing any final guidance."
- The New York Department of Financial Services also issued proposed guidance on managing safety and soundness risk related to climate change, which had sought to "align … with the work of federal and international banking regulators."

SEC climate rule: According to the Fall 2022 Unified Regulatory Agenda released in January 2023, the SEC has targeted finalizing its climate risk disclosure rule by April 2023. Since the release of the SEC proposed rule, Chair Gensler has acknowledged the volume of public comments and need to "really make adjustments where appropriate." The rule in its proposed form has also faced pushback from Congress including certain Senate Democrats regarding, among other things, the burdens of Scope 3 disclosure requirements.

Digital assets

Shifting of the legislative consensus: The recent turmoil in the digital assets sector has changed the debate around any possible legislation and regulation of digital assets. The failure of several large players and the associated legal fallout, including bankruptcy court rulings on ownership of customer digital assets in bankruptcy, has separated the field into those who continue to believe in a comprehensive regulatory scheme for digital assets, those who want to focus on narrower topics such as stablecoin regulation and those who advocate for regulating crypto as gambling.

- **Change in legislative control:** The Republicans who now control the House have formed a new Subcommittee on Digital Assets, Financial Technology and Inclusion as part of the House Financial Services Committee, with a stated focus on providing clear rules of the road among federal regulators, developing policies that promote fintech for underserved communities and identifying best practices and policies that continue to strengthen diversity and inclusion in the digital asset ecosystem.
- **Stablecoin legislation:** Of pending legislation, in the near-term we believe there is currently the most appetite for the consideration of targeted stablecoin legislation.
- **Appetite for comprehensive legislative reform:** Some, such as Representative Torres and the Crypto Council for Innovation, continue to believe that there is enough bipartisan support for this Congress to pass comprehensive digital asset legislation.

Digital assets

Agency action: Given the roadblocks to legislative action, we expect any near-term change to largely occur through action by the federal bank and market regulators.

- **Upcoming areas of regulatory focus:** Acting Comptroller of the Currency Hsu has flagged that the OCC is working to clarify supervisory expectations on (1) liquidity risk management of deposits from crypto-asset companies, including stablecoin issuers, (2) finder activities, especially related to crypto trade facilitation and (3) crypto custody, which are all currently permissible for national banks under the OCC's existing interpretive letters, subject to OCC review of the ability of a particular national bank to manage the risks of such activities. We expect that the Federal Reserve will also issue guidance on a range of banking-related crypto activities in the near future, with a focus on risk management.
- **Bank regulator crypto slowdown:** Each of the Federal Reserve, OCC and FDIC has taken steps to slow down expansion of digital asset activities by regulated banks by requiring supervised institutions to provide notice and effectively obtain regulatory non-objection before commencing any new activities. We expect that they will continue to adhere to this approach in 2023, at least until the issuance of additional guidance.
- **SEC enforcement:** We expect the SEC to continue its enforcement crackdown on market actors that it views as not complying with existing securities laws applicable to digital assets, including with respect to digital asset yield products as securities, manipulation in various digital asset markets and enforcement actions related to FTX. In Chair Gensler's view, "It's about compliance. There's so much non-compliance in this field. It's part of the business model."

Digital assets

- **CFPB action:** The CFPB's announcement of its intention to invoke its "dormant" statutory authority to examine certain non-depository financial institutions could signal an attempt by the CFPB to establish supervisory authority over digital asset and other fintech companies engaged in consumer payments. Furthermore, the CFPB in November 2022 issued a complaint bulletin describing a rise in consumer complaints related to digital assets and reporting a total of more than 8,300 complaints in the past four years, which could foreshadow a growing effort by the CFPB to pursue consumer financial law violations in the digital asset space.
- **NYDFS customer digital asset custody guidance:** The NYDFS, likely in response to recent bankruptcy court rulings, released guidance in January 2023 for NY-licensed trust companies and BitLicensees regarding sound custody and disclosure practices intended to better protect customers in the event of a custodian's insolvency, emphasizing the importance of ensuring that equitable and beneficial ownership always remains with the customer.

Capital and stress testing

General outlook: The U.S. banking agencies continue to review bank capital requirements in light of the finalization of the Basel III framework by the Basel Committee on Banking Supervision. No proposals for any of the components of finalizing the Basel III framework (known as the "Basel III endgame") have yet been published by the agencies.

- On September 9, 2022, the U.S. banking agencies issued a press release reaffirming "their commitment to implementing enhanced regulatory capital requirements that align with the final set of 'Basel III' standards" and stating that they "are currently developing a joint proposed rule for issuance as soon as possible."
  - Federal Reserve General Counsel Van Der Weide had earlier referred to an "aircraft carrier release," which might imply that the agencies would issue a single proposed rule covering all of the remaining aspects of the finalization of Basel III.
- Vice Chair for Supervision Barr indicated he intends to undertake a comprehensive review of capital levels beyond the Basel III endgame, stating at a November 2022 House Financial Services Committee (HFSC) hearing: "I'm undertaking a holistic review of our capital requirements. That includes the … Basel III endgame.'"
- Although this review remains ongoing, statements by Barr in a December 2022 speech suggest that:
  - Higher capital requirements may be under consideration:
    - "While the estimates vary widely, and are highly contingent on the assumptions made, the current U.S. requirements are toward the low end of the range described in most of the research literature."
    - "…I'd observe that the recent experience of the pandemic suggests that large, unexpected shocks can occur with little notice. Our inability to predict such events would argue for a higher overall capital level than one based solely on historical experience."."

Version as of 1/26/2023

Capital and stress testing

- Any proposed changes would be "adopted through the notice and comment process … and implemented with appropriate transition periods…."

Supplementary leverage ratio (SLR): The Federal Reserve announced in March 2021 that it would "soon" seek comment on measures to adjust the SLR, which would "not erode the overall strength of bank capital requirements." Although no proposal has been released, the Federal Reserve has reiterated its continued attention to SLR.

- For example, on December 1, 2022, Vice Chair for Supervision Barr stated, "We are exploring the empirical evidence and examining whether adjustments to the leverage ratio might be appropriate in the context of our holistic capital review."
- One option that the Federal Reserve could consider is a permanent exclusion from the SLR denominator for central bank reserves and potentially U.S. Treasury securities, along with adjusting the SLR minimum and buffer requirements.
  - A similar proposal has been floated by some, including Treasury Under Secretary for Domestic Finance Nellie Liang.*
  - Former Vice Chair for Supervision Quarles had earlier argued that excluding only reserves or both reserves and U.S. Treasuries would exacerbate funding preferences in the banking system. Instead, his preferred approach was to recalibrate the enhanced SLR (eSLR).

* Nellie Liang & Patrick Parkinson, *Enhancing the Liquidity of U.S. Treasury Markets Under Stress*, Brookings Institute (Dec. 16, 2020)

Capital and stress testing

Stress testing and capital planning: Vice Chair for Supervision Barr has stated, "We are currently evaluating whether the supervisory stress test that is used to set capital requirements for large banks reflects an appropriately wide range of risks [and] considering the potential for stress testing to be a tool to explore different sources of financial stress and uncover channels for contagion that lead to unanticipated consequences." Changes to stress testing and capital planning requirements might include:

- Additional scenarios or scenario components (apart from the existing Global Market Shock and Largest Counterparty Default components)
- More severe stress scenario assumptions

G-SIB requirements: Changes to the regulations applicable to G-SIBs could include adjustments to the factors underlying G-SIB surcharge scores, including further emphasis on the short-term wholesale funding factor and the possibility of a more graduated surcharge structure (i.e., reducing cliff effects)

Capital and stress testing

Other initiatives: There are a number of pending rulemaking initiatives on the banking agencies' agenda, including:

- Potential deployment of the countercyclical capital buffer (CCyB) in business-as-usual times as a potential tool for stimulating lending by reducing its calibration in stressed conditions
- Finalization of risk-based capital requirements for depository institution holding companies that are significantly engaged in insurance activities
  - The proposed rule was issued in 2019. The Fall 2022 Unified Regulatory Agenda released in January 2023 suggests that the Federal Reserve expects further action in the near term. In each previous agenda that this rule appears, further actions were expected by approximately the end of the corresponding half-year period, and in each previous case, the agencies missed their self-imposed target. This is the sixth time this final rulemaking has appeared on the short-term rulemaking agenda, going back to Spring 2020.

Capital and stress testing

- Refinement, finalization and implementation of prudential capital and liquidity treatment of cryptoasset exposures
  - On November 16, 2022, Vice Chair for Supervision Barr stated at an HFSC hearing that it is "critical" to have stablecoin issuers, both bank and nonbank, subject to "strong supervision," which would include capital and liquidity rules.
  - The Basel Committee finalized its proposal on the prudential treatment of cryptoasset exposures of banks and other institutions subject to the Basel capital framework in December 2022, which the Group of Central Bank Governors and Heads of Supervision agreed to implement by January 1, 2025.
    - The standards set forth:
      - a classification system for categories of cryptoassets for purposes of the prudential framework
      - capital and liquidity requirements and supervisory expectations for banks that engage in cryptoasset activities, including, among others:
        - an add-on to risk-weighted assets to cover infrastructure risk for all Group 1 cryptoassets (i.e., cryptoassets that meet the necessary classification conditions, such as tokenized traditional assets and stablecoins with effective stabilization mechanisms) that can be activated by regulators based on observed weaknesses in the cryptoasset's infrastructure
        - exposure limits for Group 2 cryptoassets (cryptoassets that fail to meet any of the necessary classification conditions, including unbacked cryptoassets) set at 1% and (as a fall-back) 2% of Tier 1 capital, measured as the higher of the gross long and gross short position in each cryptoasset

Capital and stress testing

- The standards would impose significant responsibilities on banks for assessing and monitoring the classification of cryptoasset exposures and, while generally applying elements of the existing Basel capital framework, would adopt a conservative approach to the proposed capital and liquidity requirements applicable to these exposures.
- The Basel Committee also agreed to monitor and review a set of issues, including statistical tests and the redemption risk test, permissionless blockchains, Group 1b cryptoassets received as collateral, hedging recognition criteria for Group 2a classification, and calibration of the Group 2 exposure limit.

Our client memorandum on the Basel Committee's finalized prudential standards on cryptoassets will be published separately.

BSA/AML

General outlook: Regulatory change to the Bank Secrecy Act (BSA)/anti-money laundering (AML) regime remains a high priority even though implementation has been very slow.

Legislative and regulatory changes: The **Anti-Money Laundering Act of 2020** (AMLA) is the most important BSA/AML legislation in years and could have a significant impact on AML compliance and supervision once it is fully implemented. FinCEN is also moving forward with a number of other rulemakings to address gaps in and modernize the U.S. AML regime.

- FinCEN has made limited progress with respect to AMLA-related and other key rulemakings due to constrained resources, however we anticipate FinCEN will prioritize the finalization of rules related to the Beneficial Ownership Registry, National AML/CFT Priorities, the amended Travel Rule and recordkeeping/reporting requirements for crypto transactions with unhosted wallets.
- The Treasury Department, in its Illicit Finance Action Plan, signaled that it is considering the feedback received on the proposed amendments to the Travel Rule and the recordkeeping/reporting requirements for crypto transactions with unhosted wallets.

Our visual memorandum on AMLA is available here.

Our client update on the U.S. Corruption Strategy is available here and our update on the National Illicit Finance Strategy is available here.

BSA/AML

AMLA implementation

- **Access Rule:** FinCEN issued a Notice of Proposed Rulemaking on December 15, 2022 that will establish the standards for financial institutions and government entities to access beneficial ownership information reported to FinCEN. **Our client update on the proposed Access Rule is available here.**
- **Beneficial Ownership Registry**: On September 30, 2022, FinCEN published the Beneficial Ownership Information Reporting Rule, which requires certain legal entities to submit their beneficial ownership and company applicant information to the agency. The Beneficial Ownership Information Reporting Rule will be effective January 1, 2024. **Our client update on the final beneficial ownership Information Reporting Rule is available here.**
- **No-Action letter process:** On June 3, 2022, FinCEN issued an ANPR to solicit comments on questions relating to the implementation of a no-action letter process.
- **Suspicious Activity Report (SAR) Sharing Pilot Program:** On January 24, 2022, FinCEN released a Notice of Proposed Rulemaking that would establish a limited-duration pilot program, permitting participant financial institutions to share SARs with their foreign branches, subsidiaries and affiliates. FinCEN expects to publish a final rule during the summer of 2023. **Our client update on the SAR sharing pilot program proposed rule is available here.**

BSA/AML

Other regulatory initiatives

- **Expanding BSA/AML requirements:** On May 13, 2022, the Treasury Department published the 2022 National Strategy for Combatting Terrorist and Other Illicit Financing, which notes potential gaps in the U.S. AML framework with respect to real estate transactions, trusts, trusts and company service providers, attorneys, investment advisors and virtual asset-related activities.
- **Exemption from SAR requirements.** On March 16, 2022, the OCC amended its SAR regulations to allow the OCC to issue exemptions from those regulations. Although neither the OCC's SAR regulations nor FinCEN's SAR regulations expressly address exemptions, FinCEN has the general authority to grant exemptions from the requirements of the BSA, which includes granting exemptions under its SAR reporting regulations.

Enforcement

- **AML supervision and enforcement:** AML is likely to continue to be a high priority for the financial regulators and, while overall enforcement numbers have been down in recent years, regulators, especially the New York State Department of Financial Services, will not hesitate to use their enforcement powers in cases involving serious AML program breakdowns.

BSA/AML

- **Greater scrutiny of fintechs/crypto:** Greater regulatory scrutiny for AML compliance is expected for Fintechs (especially payments-related) and crypto firms as they assume an increasingly important role in financial services.
  - On September 16, 2022, the U.S. Treasury and Justice Departments released regulatory and legislative recommendations and priorities to address illicit finance risks connected to the digital assets ecosystem, following President Biden's executive order on the regulation of digital assets.

Our client update on the U.S. Treasury and Justice Departments' reports is available here.

Version as of 1/26/2023

Consumer financial protection

General outlook: Under the leadership of Director Chopra, the CFPB has taken an increasingly activist approach and expanded its reach. Chopra has made it clear that the CFPB is interpreting its statutory authorities broadly to expand the CFPB's ability to pursue violations of the consumer financial laws in consumer financial markets, such as the fintech and consumer payments sectors. Despite recent legal challenges, we expect that the CFPB will continue its aggressive approach in 2023.

CFPB regulatory agenda: In December 2022 testimony before the SBC and HFSC, Director Chopra indicated that the CFPB will have the following priorities in 2023:

- Targeting enforcement actions on "repeat offenders" and "major market actors," discussed further on the next slide
- Addressing the increased offering of consumer financial services by fintechs, particularly in consumer payments
- Enhancing transparency through "dramatically" increased issuance of guidance, including advisory opinions, compliance bulletins, policy statements and other publications
- Promoting competition in the consumer financial services space
- Monitoring the encroachment of BigTech and Big Data in the consumer financial services sector
- Limiting hidden consumer fees, including bank overdraft fees and credit card late fees

Consumer financial protection

Repeat offenders and major market actors: In a March 2022 speech, Director Chopra identified "repeat offenders" and "major market actors" engaged in "large-scale harm" as an enforcement priority for the CFPB. The announcement included an initiative to impose "non-monetary" or "structural" remedies, which could include:

- Caps on a financial institution's size or growth
- Banning certain types of business practices or product lines
- Requiring divestiture of certain product lines
- Limiting leverage or requiring more equity capital
- Revoking government-granted privileges, such as deposit insurance or bank charters
- Clawbacks, forfeitures, and other changes to executive compensation for individual offenders

High-profile enforcement actions: The Director's speech was followed by a series of high-profile enforcement actions over the course of 2022 against major market actors that had been sanctioned for repeat violations.

Consumer financial protection

Repeat offender registry: In December 2022, the CFPB proposed a rule requiring certain non-depository institutions to register with the CFPB when they become subject to certain local, state or federal consumer financial protection agency or court orders. The CFPB would aggregate and publish this information via an online registry. Additionally, large supervised non-depository institutions would be required to designate an executive to submit an annual supervisory written statement attesting to the steps taken to comply with all orders.

Terms and conditions registry: In January 2023, the CFPB proposed a rule to require CFPB-supervised non-depository institutions to report to the CFPB the use of certain types of terms and conditions in form contracts with customers. The CFPB would aggregate and publish this information via an online registry.

- Specified terms and conditions that would need to be reported to the registry include clauses that waive certain customer legal protections, limit liability amounts, ban class action rights, limit enforceability of rights, restrict the ability to file complaints or impose arbitration requirements.
- The proposal is perceived as an attempt by the CFPB to pressure supervised non-depository institutions to remove clauses from customer contracts that are legal but disfavored by the CFPB, such as arbitration clauses.

BNPL products: The risks of buy now, pay later (BNPL) products as a substitute for credit cards will be an area of focus in 2023, particularly after the CFPB's September 2022 report on the rapid rise of BNPL products since 2019.

Consumer financial protection

Bank overdraft fee guidance: In October 2022, the CFPB issued guidance documents clarifying that certain bank overdraft fees can be violations of the consumer financial protection laws.

- Consumer Financial Protection Circular 2022-06 identified as a potential unfair or deceptive act or practice (UDAAP) violation the charging of unanticipated overdraft fees, specifically those overdraft fees charged when a consumer would not reasonably expect to be charged a fee. The CFPB clarified that a violation would occur if the bank had “authorize positive, settle negative” fees, specifically those policies that charge an overdraft fee when the consumer had enough money in an account to cover a debit charge at the time of bank authorization of payment, but intervening authorizations caused the payment to overdraft.
- Compliance bulletin 2022-06 identified as a potential UDAAP violation the charging of “returned deposited item” fees, as in fees charged when a consumer attempts to deposit a check that cannot be processed due to insufficient funds held by the originator of the check. However, no penalties will be sought for such fees assessed before November 1, 2023.

Credit card late fees: In 2022, the CFPB issued an ANPR to consider adjustments to certain consumer protection regulations to limit credit card late fees imposed by card issuers. In particular, the ANPR considers limiting the inflation-adjusted safe harbor under Regulation Z, which currently allows card issuers to charge up to $30 for a first late payment and $41 for subsequent late payments. The CFPB seeks to propose a rule on credit card fees in 2023.

Hidden consumer fees: The CFPB actions on bank overdraft fees and credit card fees are part of an interagency effort by the Biden Administration to address “hidden” consumer fees.

Consumer financial protection

BigTech: The CFPB is focused on the rise of BigTech in financial services and financial data collection.

- The CFPB has repeatedly ordered large technology companies operating payments systems to report business practice information, and the CFPB is likely to continue these efforts in 2023.
- As discussed in more detail in the Open banking and data access section on slide 32, in late 2022, the CFPB launched the rulemaking process to implement Section 1033 of the Dodd-Frank Act, which would give customers more control over personal financial data held by financial institutions and large technology companies.

Digital assets: Recent developments indicate that the CFPB is poised to take an increasingly active role in monitoring the consumer protection aspects of the digital asset industry in 2023. See slides 9 – 11 in the Digital assets section for further discussion of certain CFPB actions regarding digital assets.

Expanded supervision of nonbanks and fintech: In early 2022, the CFPB announced its intention to invoke its “dormant” statutory authority to examine non-depository companies providing consumer financial products or services that it has “reasonable cause” to believe pose risks to consumers. The CFPB’s announcement is a response to the rapid growth of consumer financial services offered by fintechs and signals that the CFPB will likely expand its scrutiny of fintechs in 2023.

- **Our client memorandum on the CFPB’s announcement is available here.**

The CFPB in court

Community Financial Services Association of America, et al. v. CFPB**:** In October 2022, the Fifth Circuit held that the CFPB's funding mechanism is unconstitutional because it violates the appropriations clause of the Constitution. As a remedy, the Fifth Circuit vacated the challenged aspects of the CFPB's 2017 Payday Lending Rule as "the product of the Bureau's unconstitutional funding scheme" and rendered judgement in favor of the financial services trade associations challenging the rule.

Aftermath of the Fifth Circuit's ruling: In November 2022, the CFPB filed a *certiorari* petition with the U.S. Supreme Court seeking review of the Fifth Circuit's decision. In December 2022, Democratic and Republican attorneys general filed separate amicus briefs asking the Supreme Court to grant the petition for *certiorari*.

Implications of the Fifth Circuit's ruling: Given the importance of this issue, it appears likely that the Supreme Court will grant the CFPB's petition for *certiorari*.

- Although the impact of the court case on day-to-day consumer law may be limited for the immediate future, we expect many defendants in other pending CFPB cases to use the case to delay or fight enforcement actions. For example, in December 2022, a New York federal judge stayed the CFPB enforcement action against MoneyGram while the Supreme Court decides whether to grant the CFPB's petition for *certiorari*.
- The impact of the Fifth Circuit's ruling on other self-funded agencies, like the Federal Reserve, the FDIC, the OCC and the NCUA is unclear, despite the Fifth Circuit's strong distinguishing language, which noted that the CFPB's perpetual self-directed, double-insulated funding structure is unique even among other self-funded agencies.

The CFPB in court

- The Fifth Circuit opinion has led to speculation that Congress could consider legislative solutions to subject the CFPB to the appropriations process.
  - Adding the CFPB to the appropriations process would require the CFPB to request funding from Congress each year, subject CFPB funding to annual review by the Appropriations Committees, and include CFPB funding in periodic high stakes negotiations over government-wide spending packages.
  - However, Congress appears unlikely to agree upon a solution this year, as Congress adjusts to divided control between the Senate and the House of Representatives.

AI and alternative data

General outlook: The use of AI and alternative data is expected to remain a focus for federal regulators in 2023, particularly in light of the increasing public interest in AI spurred by ChatGPT.

– **Regulatory developments:** Regulatory and policy developments by agencies such as the CFPB, OCC, FTC and HUD will continue to focus on the responsible deployment of AI and other automated systems.
  - **CFPB:** The CFPB is also working to address algorithmic discrimination in the financial sector and is hiring technologists to staff this oversight work. Financial institutions that use AI tools can also anticipate further guidance from the CFPB on:
    - Application of the Equal Credit Opportunity Act to decisions made with “complex algorithms” and the potential for such algorithms to violate consumer rights and create an unfair “two-tier system” through the implementation of its Equity Action Plan
    - Targeting of digital marketing algorithms through a new interpretive rule, including ad targeting and delivery algorithms
    - Regulations that require creditors to provide specific and accurate explanations to consumers when credit applications are denied or other adverse actions are taken, even if the creditor is using a black-box algorithmic model

AI and alternative data

- **OCC and FTC:** The OCC has announced that it will establish an Office of Financial Technology in 2023, which will include the OCC's existing Office of Innovation and focus on fostering “responsible financial innovation.” The FTC is expected to issue a rulemaking to limit privacy abuses, and ensure that algorithmic decision-making does not result in unlawful discrimination.as mandated by the Section 5 of the FTC Act.
- **HUD and others:** In 2023, federal agencies that regulate mortgage financing are expected to include a nondiscrimination quality control standard in proposed rules for automated valuation models to prevent the use of biased data that could replicate past discrimination in housing.

We expect continued focus on the responsible use of AI and alternative data in the coming year through the introduction of relevant legislative proposals.

– **Legislative developments:** It is likely that the following legislative or similar proposals will continue to be introduced in 2023 as part of the ongoing dialogue around ensuring the responsible and ethical use of AI in the financial services sector:
  - **Algorithmic Accountability Act:** This proposal requires companies to assess the impacts of automating critical decision-making processes and mandates the FTC to create regulations and report on trends within AI.
  - **The American Data Privacy and Protection Act:** This proposal has been introduced to prevent covered entities from collecting, processing, or transferring covered data in a discriminatory manner and require large data holders to conduct impact assessments and design evaluations of certain algorithms.

AI and alternative data

- **AI Bill of Rights:** The White House Office of Science and Technology Policy is expected to continue promoting the AI Bill of Rights, which aims to prevent the use of unsafe and biased automated systems and data practices and give users more control over their data. This guidance covers financial system algorithms such as loan allocation algorithms and automated interest rate determinations, as well as housing-related systems such as automated valuation systems used in mortgage underwriting or insurance.
- **Other developments:** Executive Order 13960 directs federal agencies to be transparent about their use of AI and to conduct an annual inventory of their AI use cases, which will be published to the extent possible.
  - In 2023, the Biden Administration will continue to publish its inventories of non-classified and non-sensitive government AI use cases across all agencies. Agencies are currently implementing their developed and approved plans to ensure AI systems are consistent with antidiscrimination laws and policies.

Open banking and data access

Potential move toward open banking

- The CFPB is expected to propose soon a rule to implement Section 1033 of the Dodd-Frank Act, which provides for consumer rights to access financial records.
  - In October 2020, the CFPB issued a Section 1033 ANPR soliciting public comments. Two years later, in October 2022, the CFPB released an outline of the proposals it is considering in connection with the Section 1033 rulemaking, with a comment deadline of January 25, 2023.
  - Director Chopra has indicated that the Section 1033 proposed rule will be released later in 2023.
- The CFPB has also issued orders in connection with the Section 1033 proposals to several technology companies seeking information on their data collection practices and payments products. Director Chopra released a statement that the information collection effort will "yield insights that may help the CFPB to implement other statutory responsibilities, including any [Section 1033] potential rulemaking."
- Both banks and the fintechs they compete with are unhappy with the financial data status quo.
  - Banks have long objected to screen scraping and other techniques used by some fintechs to share financial data, and in response to consumer demand, many have entered into agreements with fintechs to share data through APIs. Such partnerships can be burdensome from a third-party risk management perspective.
  - Any rule implementing Section 1033 is likely to have a significant impact on the development of the fintech industry and, depending on the specifics, may either increase or decrease the prevalence of partnerships between fintechs and banks.

Securities market structure

General outlook: Regulatory change to securities market structure and practices is a priority for the SEC under Chair Gensler and the Treasury under Secretary Yellen, especially for retail public equity trading and U.S. Treasury markets. We expect a vigorous public policy debate in early 2023 around these proposals.

Equity market reforms: The SEC in December 2022 proposed a set of sweeping equity market structure reforms across four rule proposals that would make highly significant changes to how NMS stock orders are priced, executed and reported. The proposals include:

- A new requirement for certain retail orders to be subject to order-by-order competition, rather than being routed directly to market makers
- An SEC-level best execution rule
- An adjustment to the tick sizes at which NMS stocks can be quoted or traded
- A proposal to expand the scope and manner of execution information that is reported under Regulation NMS Rule 605

Our client update discussing this package of reforms, "Going once, going twice: *SEC proposes package of equity market structure proposals*," is available here.

Securities market structure

Settlement cycle: In February 2022, the SEC proposed new rules to shorten the securities settlement cycle to one business day for most transactions. **Our client update, "*SEC proposes shortened settlement cycle,*" is available here.**

Dealer definition: In March 2022, the SEC proposed new rules expanding what constitutes a securities and government securities dealer. **Our client update, "*SEC proposes requiring many private funds and proprietary trading vehicles to register as 'dealers',*" is available here.**

Treasury market reforms: In March 2020, the onset of the COVID-19 pandemic triggered a significant pricing disruption in the U.S. Treasury market as many investors sought to liquidate holdings of Treasuries faster than Treasury dealers were able to accommodate.

- In September 2022, the SEC proposed new rules to expand central clearing in Treasury markets, including Treasury transactions and Treasury repos.
  - The proposal would require clearinghouses to expand central clearing of Treasuries by:
    - Requiring their members to submit for clearing 1) all repurchase and reverse repurchase agreements backed by Treasuries; 2) all transactions entered into by a member serving as an interdealer broker; and 3) all transactions between a member and a registered broker-dealer, government securities broker, government securities dealer, hedge fund, or leveraged account held by a broker-dealer; and
    - Facilitating access to clearing services for indirect participants.

Securities market structure

   - The proposed rules would also require broker-dealers transacting in Treasuries, including Treasury repo and reverse repo agreements, to post margin with clearinghouses for their proprietary trading separately from the margin they post for their customers' trades. To alleviate the impact of substantially increasing margin that broker-dealers would be required to post to a clearinghouse, the proposed rules would also permit broker-dealers to use customer assets as margin for customer trades by amending the customer protection rule to permit broker-dealers to include a debit in the customer reserve formula equal to the amount of margin posted at a clearinghouse for Treasuries, subject to certain conditions.

– In January 2022, the SEC proposed new rules that would no longer exempt Treasury trading platforms from Regulation ATS.

   - The proposed rules would apply Regulation ATS to currently exempt trading platforms that trade large volumes of U.S. government securities or repurchase and reverse repurchase agreements on government securities. These trading platforms would then need to comply with investor protection, fair access, and integrity of technology infrastructure regulations.
   - The proposal would also expand the scope of systems that are within the definition of "exchange," and therefore must either register or operate as an ATS, to include various broker-dealer operated communication systems that receive indications of users' interest to trade, but do not execute orders.

DOL fiduciary rule

DOL fiduciary rule: The Biden Administration will begin a new chapter in the long and tortuous history of the DOL fiduciary rule. After the Fifth Circuit had vacated an earlier, Obama-era version of the fiduciary rule in 2018, the Trump-era DOL in June 2020 proposed and in December 2020 finalized a more industry-friendly version of the rule, which took effect in February 2021.

- The now-effective DOL fiduciary rule reinstates the five-part test for defining an investment advice fiduciary that had previously been in effect since 1975, which many regard as impeding DOL enforcement due to its complexity.
- Though some were surprised that the incoming Biden Administration did not prevent the 2020 rule from taking effect, the DOL under new leadership in April 2021 announced its intent to amend or revoke many of the Trump-era changes through notice-and-comment rulemaking.
- In March 2022, consumer advocacy groups published an open letter urging the DOL to act on the intentions to reform the DOL fiduciary rule as announced in April 2021.
- While a revised version of the DOL rule was expected to be published in December 2022, new reports are emerging that there may be delays as the rule has not been sent for Office of Management and Budget review. See here. A revised version of the rule is now expected to be published in 2023.