Client Update
CHOICE 2.0 and New Presidential Memoranda

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INTRODUCTION

On Thursday, May 4, 2017, the House Financial Services Committee passed the Financial CHOICE Act of 2017, H.R. 10, by a strict party-line vote. The bill, which has been referred to as "CHOICE 2.0," because it is a revised version of legislation that was considered in the House in the previous congressional session, would repeal, modify and substantively revise many provisions of the Dodd-Frank Act. Earlier, on April 21, 2017, President Trump issued Presidential Memoranda regarding other aspects of the Dodd-Frank Act—specifically, the Orderly Liquidation Authority ("OLA") and the functioning of the Financial Stability Oversight Council ("FSOC"). This Client Update discusses these developments.

CHOICE 2.0 is sweeping legislation that includes 10 separate titles and stretches to well over 500 pages. This Client Update discusses aspects of CHOICE 2.0 that may be particularly important to banks and other depository organizations, including: (a) important changes to capital and stress testing requirements; (b) changes to the "living will" process; (c) administrative and procedural revisions to financial regulatory rulemaking processes; (d) revisions to the Department of Labor's ("DOL") Fiduciary Rule; and (e) changes to the structure and operation of the Consumer Financial Protection Bureau ("CFPB"). We have discussed other aspects of CHOICE 2.0 in a prior client update.[1]

As it is currently structured, CHOICE 2.0 appears highly unlikely to garner any Democratic support, even though some individual reforms embodied in the bill draw bipartisan support. House Democrat leaders have derisively referred to the

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1 For more information regarding the implications of CHOICE 2.0 on the SEC and Capital Markets, see our April 25, 2017, client update, "Financial CHOICE Act 2.0: Implications for the SEC and Capital Markets," available here.

bill as "the Wrong Choice Act." Depending on how moderate Republicans decide to vote, the bill also may not garner enough support to pass the House. Even if it is approved in the House, CHOICE 2.0 likely will not be accepted as is by the Senate, which is likely to progress with more moderate and modest reform efforts.

While these legislative battles continue, the new administration also moves forward with its reform efforts. The two Presidential Memoranda, which are also a subject of this Client Update, reflect additional White House efforts in this regard.

We will continue to monitor developments in these areas closely and will provide additional analysis as Congress and the administration pursue financial regulatory reform, including in the forthcoming report by the Treasury Department that is required by the President's February 3, 2017, Executive Order on "Core Principles for Regulating the United States Financial System" (the "Core Principles").[2]

KEY ASPECTS OF CHOICE ACT FRAMEWORK

CHOICE 2.0, like its predecessor, is designed to give banking institutions a "choice" with respect to the regulatory framework that is applicable to them. That is, the basic concept of the legislation is to provide a so-called "off-ramp" from certain provisions of the Dodd-Frank Act and the regulations implementing Basel III reforms. Banking organizations would be eligible to take this "off-ramp" if they meet certain capital requirements—specifically, a 10% non-risk weighted leverage ratio threshold.

CHOICE 2.0 also includes other significant reforms and regulatory revisions, including the following:

- Repeal of FSOC's authority, among others things, (a) to designate non-bank financial companies for supervision by the Federal Reserve Board ("FRB") and (b) to recommend enhanced prudential standards for large, interconnected bank holding companies ("BHCs").
- Repeal of the Volcker Rule, which restricts the proprietary trading and private fund activities of banking organizations and their affiliates.

[2] For more information regarding the Core Principles, see our February 5, 2017, client update, "Executive Order and DOL Memo Signal Shift in Federal Financial Regulatory Agenda," available here.

- Structural changes to the CFPB and changes to its jurisdictional reach.
- Changes with respect to federal financial regulatory agencies' participation in international standard-setting processes, such as the Basel Committee on Banking Supervision ("BCBS").
- Elimination of the so-called "Durbin Amendment," which limits fees charged to retailers for debit card processing.
- Fundamental changes to the administrative processes that apply to federal financial regulatory agencies, including a repeal of the *Chevron* deference standard.

CHOICE 2.0'S CHANGES REGARDING CAPITAL AND STRESS TESTING REQUIREMENTS

Qualifying Banking Organization ("QBO") Changes

As noted, a key feature of CHOICE 2.0 is the introduction of an "off-ramp" that offers QBOs that maintain a leverage capital ratio of at least 10% relief from capital, liquidity and other enhanced prudential standards promulgated under the Dodd-Frank Act and pursuant to the U.S. implementation of Basel III. CHOICE 2.0 also would exclude QBOs from all stress testing requirements, including Dodd-Frank Act stress tests currently required under Section 165(i). This also would appear to exclude a QBO from the FRB's Comprehensive Capital Analysis and Review ("CCAR") program.

CHOICE 2.0 differs from CHOICE 1.0 by eliminating a supervisory qualification requirement found in the prior legislation. CHOICE 1.0 had required that banking organizations, in order to be QBOs, maintain a composite CAMELS rating of "1" or "2."

Like CHOICE 1.0, for the purposes of CHOICE 2.0's "off-ramp," the leverage ratio denominator would be calculated using the so-called "supplementary leverage ratio" as in effect on the date of the enactment of CHOICE 2.0 (this is a modified version of the ordinary "tier 1" leverage ratio that includes on-balance sheet assets as well as certain off-balance sheet items, such as guarantees, unfunded commitments and potential future exposure associated with derivatives).

Operational Risk Capital

CHOICE 2.0 contains a number of provisions relating to operational risk capital, a key component of certain large banking organizations' capital requirements that have become increasingly burdensome over the past several years. Currently, only the largest, most internationally active banking organizations (those subject to the advanced approaches capital rules) are required to model their operational risk exposure and hold capital against that risk under the U.S. risk-based capital rules.

Industry criticism of the current rules' approach to operational risk capital includes that they rely too heavily on historical losses and are not appropriately sensitive to either a banking organization's current operational risk environment or the use of operational risk mitigants (*e.g.*, insurance). CHOICE 2.0 appears to respond to some of these criticisms by prohibiting the federal banking agencies from establishing operational risk capital requirements unless such requirements: (a) are based on the risks of a banking organization's current activities and businesses; (b) are appropriately sensitive to the risks posed by such current activities and businesses; (c) are determined under a forward-looking assessment of potential losses that may arise out of a banking organization's current activities and businesses, which is not solely based on a banking organization's historical losses; and (d) permit adjustments based on qualifying operational risk mitigants.

If these provisions were to be enacted, non-QBOs that calculate capital under the advanced approaches could experience significant capital relief.

Stress Testing and CCAR Changes

CHOICE 2.0 includes several changes that would ease the burden of stress testing and CCAR. In particular, CHOICE 2.0 would: (a) require CCAR to run on a two-year, rather than a one-year, planning cycle; (b) eliminate the mid-year Dodd-Frank Act stress tests; (c) incorporate certain recommendations to improve the stress testing processes made by the Governmental Accountability Office in November 2016; (d) effectively eliminate the qualitative component of CCAR (*i.e.*, the FRB would no longer be able to object to a banking organization's capital plan solely on a qualitative basis); and (e) as mentioned above, exclude QBOs from all stress testing requirements.

CHOICE 2.0'S CHANGES TO THE LIVING WILL PROCESS

To conform with CHOICE 2.0's proposal to repeal the OLA (which is consistent with CHOICE 1.0), CHOICE 2.0 proposes to remove the FDIC from the Dodd-Frank Act's living will process for nonbank financial companies supervised by the FRB and BHCs with total consolidated assets equal to or greater than $50 billion.

CHOICE 2.0'S ADMINISTRATIVE & PROCEDURAL PROVISIONS

International Processes

CHOICE 2.0 would require the applicable U.S. regulator to solicit public notice and comment with respect to the subject-matter, scope and goals of any participation in international standard-setting processes, such as the BCBS. This change would require a shift in how the U.S. agencies currently choose to participate in the BCBS, which is largely without public consultation, and could diminish the extent to which the United States is able to participate in such international standard-setting fora.

Unfunded Mandates Reform

CHOICE 2.0 would require the federal financial regulators—including the federal banking agencies, the CFPB, Commodities Futures Trading Commission and Securities and Exchange Commission—to comply with requirements similar to those found in the Unfunded Mandates Reform Act of 1995, subject to the oversight of the Office of Information and Regulatory Affairs ("OIRA") within the Office of Management and Budget. This requirement would call on affected regulators, when promulgating a rule that would cause an annual expenditure of $100 million or more by state or local governments or the private sector (a "Significant Mandate"), to conduct an enhanced cost benefit analysis.[3]

Generally, for the development of regulatory proposals containing Significant Mandates, these regulators would be required to establish a formal consultation process to garner input from government officials at the state and local level and affected parties in the private sector. Regulators also would be required to publish a written statement within a certain amount of time before or after issuing a general notice of proposed rulemaking or a final rule, explaining, among other things, the consultation process, a summary of the comments received during the process, the regulator's evaluation of such comments and estimates by the regulator of any future compliance costs of the mandate. Regulators also would need to "identify and consider a reasonable number of regulatory alternatives and from those alternatives select the least costly, most cost-effective or least burdensome alternative that achieves the objectives of the rule," unless the agency head includes "an explanation of why the least costly, most

[3] Moreover, CHOICE 2.0 continues to propose increased congressional oversight for rules classified as "major" or "nonmajor." For more information regarding the oversight as proposed in CHOICE 1.0 (which, other than its transfer from Title VI to Title III, remains unchanged in CHOICE 2.0), see our November 30, 2016, client update, "The Outlook for Financial Regulatory Reform Under President Trump," available here.

cost-effective or least burdensome method of achieving the objectives of the rule was not adopted" or "the provisions are inconsistent with law."

The effect of this type of process likely will be to slow rulemaking processes for Significant Mandates.

CHOICE 2.0'S CHANGES TO THE DOL FIDUCIARY RULE

Like CHOICE 1.0, CHOICE 2.0 expressly repeals the DOL's April 2016 rule defining the term "fiduciary."[4] Similarly, it continues to provide for a stay on DOL rules defining fiduciaries until 60 days after the SEC promulgates a final rule addressing the standards of conduct for securities broker-dealers.

CHOICE 2.0, however, is more prescriptive than CHOICE 1.0 with respect to actions taken by the DOL at the expiration of the 60-day stay, requiring that, if the DOL issues a regulation to address when an individual is considered a fiduciary, it must prescribe a "substantially identical definition" of "fiduciary investment advice" and impose "substantially identical standards of care and conditions" as those imposed by the SEC on brokers, dealers, or investment advisers.

CHOICE 2.0'S CHANGES TO THE CFPB

In many respects, the changes to the CFPB go beyond those contemplated in CHOICE 1.0. Most significantly, CHOICE 2.0 would eliminate the CFPB's supervisory authority and limit its rulemaking and enforcement authority to certain enumerated consumer financial protection laws, thereby removing its ability to regulate various products and to bring actions against unfair and deceptive practices more generally.

The mandate of the agency would be modified to "enforce Federal consumer financial law consistently for the purpose of strengthening participation in markets … without Government interference or subsidies, to increase competition and enhance consumer choice." Given the focus solely on enforcement, the CFPB would be renamed as the "Consumer Law Enforcement Agency."

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[4] For more information regarding the status of the DOL's fiduciary duty rule, see our February 5, 2017, Client Update, "Executive Order and DOL Memo Signal Shift in Federal Financial Regulatory Agenda," available here.

Structural Changes

In addition to shifting the purpose of the agency, CHOICE 2.0 would make the following structural changes:

- As opposed to a commission-based structure (as would have been implemented in CHOICE 1.0), the CFPB would maintain a Director as well as Deputy Director, both of whom would be appointed and removable at will by the President. The retention of the single director model likely reflects a desire to allow the current administration to select the next director, rather than requiring the congressional confirmation for a commission structure. Moreover, CHOICE 2.0 would effectively enable the President to skirt the Senate confirmation requirement for the Director by creating a vacancy in the office of the Director and appointing a Deputy Director (whose appointment does not require Senate approval), who would serve as acting Director until the time such position is filled.
- Specific functional offices, including those required under the Dodd-Frank Act, would become optional, the likely effect of which would be the downsizing or elimination of some of the offices.[5]
- The bill would create an Office of Economics, which would report directly to the Director and would provide cost-benefit analysis of all rulemaking and enforcement actions. For rulemakings, the Office of Economics would be required to: (a) review all proposed regulations; (b) assess the impact of such rules and regulations on "consumer choice, price and access to credit products"; and (c) publish a report on this assessment. Every rule and regulation issued by the agency would be required to be reviewed one, two, six and eleven years after the issuing date. In addition, the Office of Economics would be required to conduct a cost-benefit and impact analysis of all CFPB complaints or lawsuits. Again, the likely impact of these changes would be less rulemaking and enforcement activities overall.

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5 The offices that would become optional include the Office of Fair Lending and Equal Opportunity, the Office of Community Affairs, the Office of Financial Education, the Office of Financial Protection for Older Americans and the Office of Service Member Affairs. The Office of Research, which currently supports the CFPB's underlying policies and rulemaking through its economic analysis and research, also would be optional, suggesting that rulemaking itself would be less of an overall focus of the agency. In addition, the Office of Consumer Response would continue to be mandatory, but it would no longer prepare reports to Congress related to supervision and enforcement activities. The consumer complaint database would no longer be publicly available.

- Appropriations for the agency no longer would come from the FRB but, rather, directly from Congress. In addition, an Office of Inspector General would be established specific to the agency, rather than relying on the FRB's Inspector General.

Changes to Authority and Functions

CHOICE 2.0 would also significantly change a range of CFPB authorities and functions:

- The CFPB's supervisory authority would be eliminated, and its enforcement authority would no longer include the ability to bring actions for unfair, deceptive or abusive acts or practices ("UDAAP"), although other federal banking regulators would continue to have authority to bring actions for unfair or deceptive acts or practices ("UDAP"). Many of the CFPB's enforcement activities have focused on alleged UDAAP violations, so this curtailment would significantly reduce enforcement actions. In addition, the CFPB no longer would have authority over payday, vehicle title or other similar small-dollar loans or authority to restrict mandatory pre-dispute arbitration. These changes are directed at reversing current proposed rules or halting the CFPB's preliminary rulemaking processes addressing these topics.
- The CFPB would be required to provide advisory opinions about conduct contemplated by a covered person (*e.g.*, any person engaged in offering or providing a consumer financial product or service, or any affiliate of such a person if the affiliate acts as a service provider to such person), a measure that many in the industry have advocated. As part of this new requirement, CHOICE 2.0 explicitly provides that any person may rely on an opinion issued by the Director and that liability shall not attach where such person has engaged in conduct consistent with the advisory opinion.
- The bill would impose two significant limits on the CFPB's enforcement authority: (a) private parties would be able opt out of an administrative proceeding and instead compel the agency to bring a civil action against them; and (b) agency civil investigative demands would be appealable to federal court. Both of these provisions would permit parties subject to a CFPB investigation or administrative proceeding to request judicial review of the action, which would effectively limit the CFPB's ability to levy civil money penalties without judicial oversight.
- The CFPB no longer would have market monitoring functions for the purposes of researching and studying the various consumer financial products in order to determine any potential issues or risks affecting consumers (*i.e.*, those offices currently consisting of Card & Payment,

Consumer Lending, Reporting & Collection, Mortgage, and Small Business Lending Markets), and the CFPB's advisory board, made up of external industry experts, also would be eliminated. The elimination of both functions further demonstrates the contraction of the CFPB's ability to conduct rulemaking or otherwise address emerging risks or issues impacting consumers.

- Other proposed changes include: (a) requiring the CFPB to reissue guidance, on public notice and comment, regarding indirect auto lending; (b) striking the Durbin Amendment, under Section 1075 of the Dodd-Frank Act, on interchange fee limits; and (c) granting OIRA authority over the agency to the same extent as its authority over the federal executive departments.

PRESIDENTIAL MEMORANDA

On April 21, 2017, President Trump issued two Presidential Memoranda, one addressing the OLA and the other addressing the FSOC.

Orderly Liquidation Authority

The Dodd-Frank Act established the OLA, through which a financial company could be placed in receivership led by the FDIC on determination that the company is in default or in danger of default and its failure and resolution under otherwise applicable insolvency law would have serious adverse effects on U.S. financial stability.[6] Due to concern that the OLA and the related Orderly Liquidation Fund creates moral hazard by encouraging excessive risk-taking by creditors, counterparties and shareholders of financial companies, the President has directed the Secretary of Treasury to "understand OLA's full contours and acknowledge the potentially adverse consequences of its availability and use."

The Secretary must provide a report to the President within 180 days of the date of the Presidential Memorandum considering, among other things, the potential adverse effects of failing financial companies on U.S. financial stability, a determination and explanation of whether the framework for using the OLA is consistent with the President's Core Principles, whether the availability or use of OLA leads to excessive risk-taking and whether a new chapter in the U.S. Bankruptcy Code would be a better method to resolve financial companies.

Moreover, the President has directed the Secretary to put a temporary hold on making determinations under the OLA unless, in consultation with the President, the Secretary determines that the criteria relating to an entity's

[6] CHOICE 2.0, like its 1.0 predecessor, continues to propose an express repeal of the OLA.

harmful impact on the financial stability—those enumerated in § 203(b) of the Dodd-Frank Act—require otherwise.

Former FRB Governor Daniel Tarullo recently provided his own assessment of the OLA, noting the importance of credible resolution mechanisms for preventing bank runs and systemic risk. He warned that repealing the resolution powers without sufficient changes to the Bankruptcy Code would be "dangerous"—that the "potential for Lehman-like failures would increase, moral hazard would strengthen, and a future government would be more likely to have to scramble to find new ways of helping a large failing firm."[7]

FSOC

FSOC was created by the Dodd-Frank Act to, among other things, make determinations of whether a nonbank financial company is "systemically important." If FSOC makes such a determination, the relevant nonbank financial company becomes subject to FRB supervision and enhanced prudential standards.

Noting that such determinations and designations have significant implications for affected entities, the industries in which they operate and the economy, the President directed the Treasury Secretary to review the FSOC determination and designation process and report within 180 days of the date of the Presidential Memorandum. In particular, the President noted the significance of ensuring that determinations of systemic importance promote market discipline and reduce systemic risk, and that once an entity is notified by FSOC that it is under review, the entity is afforded a due, fair and appropriately transparent process.

Moreover, the report is to address whether FSOC's determination and designation processes are consistent with the Core Principles and make any applicable legislative and regulatory recommendations to ensure consistency with the Core Principles. In addition to covering nonbank financial company designations, the Memorandum also covers FSOC's authority to designate financial market utilities and financial activities as systemically important.

Similar to the Memorandum addressing the OLA, the President has required the Secretary to put a temporary hold on any nonemergency proposed determinations and designations. FSOC convened a meeting in executive session

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[7] Daniel K. Tarullo, *The Misguided Proposal to Repeal Title II of Dodd-Frank*, MIT GOLUB CTR. FOR FIN. AND POL'Y (May 8, 2017 9:54 AM), http://gcfp.mit.edu/tarullo-guest-blog/; *see also* John Heltman, *Repealing FDIC Resolution Powers Would Be 'Dangerous,' Tarullo Warns*, AM. BANKER (May 9, 2017 1:15 PM), https://www.americanbanker.com/news/repealing-fdic-resolution-powers-would-be-dangerous-tarullo-warns.

on May 8, during which the Council received an update from Treasury Department staff on the Presidential Memorandum, and discussed the ongoing annual reevaluation of a designated firm.[8]

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Please do not hesitate to contact us with any questions.

[8] On April 24, MetLife, Inc. ("MetLife"), which has been in litigation challenging its 2014 designation as a non-bank systemically important financial institution, filed a motion in the D.C. Circuit to suspend the litigation, pending Treasury's forthcoming report pursuant to the Memorandum. While FSOC did not take a position on MetLife's motion, FSOC expressly consented to a 60-day abeyance. The D.C. Circuit has yet to rule on the motion. The case can be found at: MetLife, Inc. v. Fin. Stability Oversight Council, No. 16-cv-05086 (D.C. Cir. filed June 6, 2016).