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Financial Regulation Alert

Treasury Report Proposes Revamping Post-Crash Financial Regulation

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I. Summary

On June 12, 2017, the U.S. Treasury Department released a 150-page report (the Report) that recommends revamping many of the rules for banks and other financial services firms put in place after the 2008 financial crisis through the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).¹ While some in Washington believed that the Report would simply recommend unwinding Dodd-Frank, the Report is being received as a serious effort to put forth good-faith proposals to improve the financial regulatory ecosystem and a valuable contribution to the debate over financial regulatory reform.

The Report, which is the first of four to be prepared in response to an executive order (EO) President Trump signed in February 2017, recommends more than 100 changes to financial rules, many of which will not require congressional authorization. According to Craig Phillips, the Treasury official leading the financial regulatory review process, two-thirds of the Report's proposals can be carried out by regulators without any congressional action. This could signal the administration's intent to move swiftly to address some issues through the regulatory process, bypassing potential legislative obstacles. Phillips said that the remaining EO-required reports are unlikely to be completed before Labor Day.²

Overall, the Report recommends streamlining supervision of the financial sector and giving political appointees more influence over the process while taking some power away from independent regulators. Although the Report does not recommend repeal of Dodd-Frank, it suggests changes to many of the law's major provisions. The Report's recommendations include: (i) changing the enforcement authorities of the Consumer Financial Protection Bureau (CFPB) and making the CFPB director more accountable to the president; (ii) easing certain elements of the Volcker Rule; (iii) exempting many banks from certain "stress tests" and changing requirements for living wills; (iv) updating the Community Reinvestment Act (CRA); (v) increasing the power of the Financial Stability Oversight Council (FSOC); and (vi) encouraging a reconsideration of the influence of international standard-setting bodies.

¹ *A Financial System That Creates Economic Opportunities Banks and Credit Unions*, U.S. Dept. of the Treasury, June 2017, <https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf>.

² Ben White & Aubree Eliza Weaver, "Here Comes the Fed," *Politico*, June 14, 2017, <http://www.politico.com/tipsheets/morning-money/2017/06/14/here-comes-the-fed-220825>.

Along with the Financial CHOICE Act passed by the House of Representatives on June 8, 2017, the Report will frame the debate for the Senate as it takes up the issue of financial regulatory reform. The Report gives a strong indication of Treasury's approach to financial regulation, an approach it may well embrace as it works with Congress to effect regulatory change. Among other themes, the Report emphasizes:

- Tailoring rules to the size/complexity of institutions;
- Reducing regulations deemed unnecessary;
- Promoting transparency of regulatory requirements and processes;
- Improving regulatory coherence; and
- Increasing political control of regulatory bodies.

II. History

In January, President Trump pledged to revisit the Dodd-Frank Act.³ On February 3, 2017, the president signed Executive Order 13772, which ordered a comprehensive review of financial regulations.⁴ The Treasury Secretary was ordered to “identify any laws, treaties, regulations, guidance, reporting and recordkeeping requirements, and other Government policies that inhibit Federal regulation of the United States financial system in a manner consistent with” a set of “Core Principles.”⁵

The Report, which focuses on banks, is the first of four examinations being carried out by the Treasury Department in satisfaction of the EO's requirements. The subsequent reports will address: (i) capital markets; (ii) asset management and insurance industries, and retail and institutional investment products and vehicles; and (iii) nonbank financial institutions, financial technology and financial innovation.⁶ Furthermore, Treasury will review and submit separate reports to the president on the Orderly Liquidation Authority (OLA) established in Title II of Dodd-Frank, and the process by which the FSOC determines that a nonbank financial company qualifies as a systemically important financial institution (SIFI).⁷

³ See Glenn Thrush, “Trump Vows to Dismantle Dodd-Frank ‘Disaster,’” *The New York Times*, Jan. 30, 2017, <https://www.nytimes.com/2017/01/30/us/politics/trump-dodd-frank-regulations.html>.

⁴ Executive Order 13772, “Core Principles for Regulating the United States Financial System,” Feb. 3, 2017, <https://www.gpo.gov/fdsys/pkg/FR-2017-02-08/html/2017-02762.htm>.

⁵ The EO stated that the White House's policy is to regulate the financial system consistent with these Core Principles: “(a) empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth; (b) prevent taxpayer-funded bailouts; (c) foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry; (d) enable American companies to be competitive with foreign firms in domestic and foreign markets; (e) advance American interests in international financial regulatory negotiations and meetings; (f) make regulation efficient, effective, and appropriately tailored; and (g) restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework.” EO 13772, § 1.

⁶ Report at 4.

⁷ *Id.*

III. Significant Recommendations in the Report

a. Consumer Financial Protection Bureau

The CFPB oversees the practices of certain companies that provide financial products and services, from credit cards and payday loans to mortgages and debt collection. According to the Report, the CFPB suffers from both an “unaccountable structure” and “unduly broad regulatory powers” leading to “abuses and excesses,” and has “hindered consumer choice and access to credit, limited innovation, and imposed undue compliance burdens, particularly on small institutions.”⁸

With respect to the CFPB’s structure and operations, the Report recommends enabling the president to remove the CFPB director at will—he can now do so only “for cause”⁹—or installing a multimember commission or board to lead the agency, such as those that head the Securities and Exchange Commission (SEC) or the Commodities Futures Trading Commission. The Report also calls for subjecting the CFPB to the annual appropriations process.

Although it does not suggest stripping the CFPB of its enforcement authority, the Report recommends that Congress eliminate the agency’s authority to supervise banks and financial companies, returning that power to other federal and state regulators, respectively, as it is “duplicative and unnecessary.”¹⁰ The CFPB has long been criticized for aggressive enforcement in areas in which it has failed to establish clear rules for firms to follow. The Report therefore recommends that the CFPB issue rules or guidance, subject to public notice and comment procedures, before bringing enforcement actions in areas where clear guidance is lacking or the agency’s position departs from the historical interpretation of law. It also recommends the CFPB bring enforcement actions in federal district court rather than in administrative proceedings.

These proposed changes to the CFPB are consistent with certain provisions of the Financial CHOICE Act, which passed the House on June 8.¹¹ The legislation would also roll back CFPB’s supervisory authority, limit its enforcement and rulemaking authority, and strike the “for cause” limit on removal.

b. Volcker Rule

Section 619 of Dodd-Frank, known as the “Volcker Rule,” generally prohibits insured depository institutions from engaging in proprietary trading (as opposed to market-making) or investing in hedge funds or private equity funds. This prohibition also applies to banks’ affiliates and holding companies, as well as certain foreign banking organizations with U.S. operations. Banking organizations have been required to comply with most provisions of the Volcker Rule since July 2015.¹²

⁸ Report at 79.

⁹ Under current law, the president can fire the CFPB director only “for cause”—in other words, if he has committed negligence or wrongdoing, not simply over a policy disagreement. This “for cause” requirement distinguishes “independent agencies,” such as the SEC, FDIC and Federal Reserve, from more traditional “executive agencies,” such as Cabinet departments, where officials serve at the pleasure of the president. However, a federal appeals court has recently ruled that this “for cause” restriction on the president’s ability to fire the CFPB director is unconstitutional because—unlike the SEC’s commission or the Federal Reserve’s board—the director is the sole head of the agency. As of this writing, the issue is still being litigated. See *generally* Lorraine Woellert, “Consumer Financial Protection Bureau Wins Rehearing on Court Ruling, in Setback to GOP,” *Politico*, Feb. 16, 2017, <http://www.politico.com/story/2017/02/consumer-financial-protection-bureau-court-ruling-235109>.

¹⁰ Report at 88.

¹¹ See *generally*, H.R. 10 – Financial CHOICE Act of 2017, <https://www.congress.gov/bill/115th-congress/house-bill/10>.

¹² Report at 71.

Rather than repealing the Volcker Rule (the approach taken in the Financial CHOICE Act), the Report recommends limiting the rule to banks with substantial trading operations. Presently, the Volcker Rule applies to *all* banking entities with more than \$50 billion in total consolidated assets. The Report would apply the Volcker Rule only to banks that have substantial trading operations and at least \$10 billion in assets.¹³ The Report also recommends simplifying the definition of proprietary trading and giving banks additional flexibility to adjust their determinations of the reasonable amount of market-making inventory under the Rule.

c. Stress Tests and Living Wills

Banks with more than \$10 billion in total assets are now required to undergo annual Dodd-Frank Act stress tests (DFASTs). The Report recommends raising this threshold to \$50 billion and giving banking regulators the flexibility to implement a threshold for mandatory stress-testing that is tailored to each entity's business model, balance sheet and organizational complexity such that even institutions with assets greater than \$50 billion could be exempt from stress-testing requirements. Among other recommendations, the Report suggests eliminating the midyear DFAST cycle and reducing the number of supervisory scenarios from three to two—the baseline and severely adverse scenarios. The Report also recommends that the Federal Reserve revise the Comprehensive Capital Analysis and Review (CCAR) process to occur every two years, instead of annually.¹⁴ Among the Report's other recommendations is a proposal to make the qualitative CCAR assessment more transparent and to provide that the qualitative CCAR element should no longer be the sole basis for the Federal Reserve's objection to bank capital plans. These proposals are in line with (but not identical to) efforts to reform or scale back DFAST and CCAR in the Financial CHOICE Act.

The Report also suggests that the living will process—the plans lenders must submit to regulators to show that they can be liquidated in an orderly fashion without threatening the financial system—should also be required every two years, instead of annually. This proposal is also consistent with the Financial CHOICE Act, which would go further and altogether repeal the OLA—the process by which the government would unwind failed complex financial institutions. The future of the OLA is expected to be discussed in upcoming reports. The Report also advises that the threshold for participation in the living will process be revised to match the revised threshold for application of the enhanced prudential standards, which it recommends be set at \$50 billion.¹⁵

d. Financial Stability Oversight Council

The Report recommends that the FSOC be given the ability to appoint a lead regulator for issue areas in which agencies have overlapping jurisdiction.¹⁶ Treasury Secretary Steve Mnuchin told a House panel that cybersecurity, for example, is one area where he thought it was clear that one agency, assigned by the FSOC, should be named the lead agency and coordinate among the rest of the agencies.¹⁷

The Report expressly states that it does not cover the FSOC SIFI-designation process. Repealing FSOC's authority to designate SIFIs is among the key provisions of the Financial

¹³ Banks would be exempt unless they have over \$1 billion in trading assets and liabilities and such assets and liabilities represent at least 10% of total assets. See Report at 73.

¹⁴ See Report at 52-54.

¹⁵ See Report at 66-68.

¹⁶ See Report at 30-31.

¹⁷ Victoria Guida & Zachary Warmbrodt, "Trump's Treasury Puts Consumer Watchdog in Crosshairs," *Politico*, June 12, 2017, <http://www.politico.com/story/2017/06/12/trumps-treasury-consumer-watchdog-financial-rules-239465>.

CHOICE Act. Further recommendations about the FSOC, including its designation authority, are expected in a later report from Treasury.

e. Community Reinvestment Act

The CRA encourages banks to serve the credit needs of the local community by requiring that banking regulators rate how well institutions meet local credit needs in their designated “assessment areas,” defined as those where institutions have local deposit-taking operations. The Report recommends that the CRA’s examinations be updated “to reflect the variety of ways banks do business and meet the needs of diverse consumers and communities” and says that consideration should also be given to “effective, innovative means of serving consumers and communities.”¹⁸

f. International Financial Regulatory Standard-Setting Processes

Echoing a White House principle to advance American interests in international financial regulatory negotiations and meetings, the Report recommends that “rigorous thought be given to the structure and mandate of [standard-setting bodies, or SSBs] as well as processes through which international financial regulatory standards are established. In particular, the United States should lead efforts to narrow the scope of SSBs’ initiatives, specifically by streamlining their mandates and eliminating existing overlapping objectives.”¹⁹ This issue bears watching as the administration begins to engage more fully with organizations such as the Basel Committee, the International Association of Insurance Supervisors and the International Organization of Securities Commissions.

IV. Going Forward

Treasury has prepared a cogent and thoughtful Report with some proposals that have bipartisan appeal, but it is unclear where the administration and the debate over financial regulatory reform go from here.

As noted above, many of the recommendations in the Report can be effected by administrative action and do not require legislative enactments. One potential obstacle, however, is that many executive branch positions remain unfilled at the relevant agencies, which could complicate implementation of administrative reforms. Further, some powers are statutorily reserved for Senate-confirmed officials and cannot be implemented by “acting” officials.

Along with the Financial CHOICE Act, the Report represents the second major Republican foray into financial regulatory reform this year. The Report may serve to focus the Republican majority in the Senate on specific reform proposals that may have a chance of passage. For example, the proposal to tailor rules to the size and complexity of an institution—particularly in the community banking space—could earn significant support from Democrats, who would generally be needed to overcome a filibuster in the Senate. The Report may also serve to focus the Republican caucus on particular reforms that might be implemented through the reconciliation process.

¹⁸ Report at 64-65.

¹⁹ Report at 55.

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