

16 June 2016

*Practice Groups:**Broker-Dealer**Global Government Solutions**Hedge Funds and Venture Funds**Investment Management, Hedge Funds and Alternative Investments**Public Policy and Law*

The Financial CHOICE Act; Dodd-Frank Reform (Not Repeal)

By Daniel F. C. Crowley, Bruce J. Heiman, William A. Kirk, Karishma Shah Page, Mark A. Roszak, and Eric A. Love

On June 7, 2016, House Financial Services Committee Chairman Jeb Hensarling (R-TX) released an executive summary of the Financial CHOICE Act (the “FCA”), his highly anticipated bill to revisit the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”). The full legislative text of the FCA is expected to be released by the end of June.

Notably, the FCA would not repeal Dodd-Frank. Instead, it addresses specific provisions of Dodd-Frank that are widely viewed as controversial, many of which have bipartisan support for reform. Among the significant provisions of Dodd-Frank that remain to be addressed are: over-the-counter derivatives, private fund adviser registration, credit rating agencies, securitization requirements, interchange fees, executive compensation and corporate governance, and conflict minerals. The FCA also covers additional areas that were not addressed in Dodd-Frank (See Additional Elements of the FCA section, below).

The FCA proposes to restructure the Consumer Financial Protection Bureau (“CFPB”) and to eliminate the ability of the Financial Stability Oversight Council (“FSOC”) to designate nonbanks for macroprudential regulation by the Board of Governors of the Federal Reserve (“Federal Reserve”). The FCA would also impose additional capital requirements on certain financial institutions as a condition for relief from some of Dodd-Frank’s most restrictive provisions, and it adds new penalties for financial industry malfeasance. In sum, despite the long-standing rhetoric about “repealing” Dodd-Frank, the FCA is more appropriately characterized as “reforming” Dodd-Frank.

Repealing FSOC’s SIFI Designation Authority

The FCA would repeal, on a retroactive basis, the authority of the FSOC to designate nonbank financial institutions as systemically important financial institutions (“SIFIs”). By way of background, the FSOC was created under Dodd-Frank to monitor the nation’s financial stability and manage systemic risks. When determining if an institution is a SIFI, the FSOC must consider the company’s leverage; the extent and nature of its off-balance-sheet exposures; the nature, scope, size, and scale of the company; and the concentration, interconnectedness, and mix of the company’s activities.

It comes as no surprise that a Dodd-Frank reform effort addresses the FSOC’s authority, given recurring criticism about the extent to which the SIFI designation process is opaque. In his speech unveiling the FCA, Chairman Hensarling alluded to this issue by saying, “Much criticism has centered on FSOC’s lack of transparency.” Republicans and many Democrats have also questioned the FSOC’s review of asset managers as potentially systemically important. There have also been legal challenges to the SIFI designation process, most

The Financial CHOICE Act; Dodd-Frank Reform (Not Repeal)

notably the U.S. District Court for the District of Columbia's recent overturning of MetLife, Inc.'s SIFI designation.

Reforming the CFPB

The FCA would replace the single-director CFPB structure with a bipartisan, five-member commission and subject the CFPB to congressional oversight and to the annual appropriations process. The CFPB's name would also be changed to the "Consumer Financial Opportunity Commission" and would be given the dual mandate of consumer protection and creation of competitive markets. The CFPB would be required to include a cost-benefit analysis performed by the Office of Economic Analysis as part of the rulemaking process. Importantly, the FCA would repeal the CFPB's recent rulemaking on arbitration clauses in consumer financial services contracts and repeal the agency's indirect auto lending guidance. Finally, the FCA would establish an independent inspector general at the CFPB.

Creating an Off-Ramp for Basel III Requirements

The FCA would create an "off-ramp" from capital and liquidity requirements under Dodd-Frank and Basel III for financial institutions that maintain a high level of capital. However, the FCA executive summary does not define "high level of capital."

The "off-ramp" would require a financial institution to maintain a specific non-risk weighted leverage ratio or risk losing its regulatory relief. Bank regulators would be allowed to conduct stress tests on the well-capitalized institutions. The FCA would also require, however, that conditions of the stress test evaluation be made public and subject to notice and comment procedures. Qualifying financial institutions would be exempt from any federal law, rule, or regulation that places limits on mergers, consolidations, or acquisitions. Lastly, qualifying institutions would be exempt from federal laws, rules, or regulations that permit a banking regulator to consider the systemic risk posed by that institution, as added to various banking laws by Section 604 of Dodd-Frank, when reviewing bank applications.

Dodd-Frank established minimum leverage and risk-based capital requirements that are determined on a consolidated basis for insured depository institutions, depository institution holding companies (including U.S. holding companies owned by foreign companies), and nonbank financial companies supervised by the Federal Reserve. Thus, bank holding companies and large nonbank financial companies supervised by the Federal Reserve must now maintain the capital and risk requirements that apply to banks.

Regulatory Relief to Community Banks

Under Dodd-Frank, depository institutions and their holding companies received new supervisory regulators, new activities restrictions and increased capital requirements, and numerous other fundamental changes in how they are regulated.

The FCA incorporates provisions from the following House Financial Services Committee or House-passed measures designed to try to provide regulatory relief to small and community financial institutions:

- H.R. 1941, the "Financial Institutions Examination Fairness and Reform Act," which would revise certain examination standards for financial institutions. H.R. 1941 has been

The Financial CHOICE Act; Dodd-Frank Reform (Not Repeal)

reported favorably out of the House Financial Services Committee and enjoys bipartisan support.

- H.R. 2896, the “Taking Account of Institutions with Low Operational Risk Act,” which would require the federal financial regulatory agencies to consider risk profiles and business models of institutions when taking regulatory actions. H.R. 2896 was reported favorably out of the House Financial Services Committee on a party-line vote.
- H.R. 766, the “Financial Institution Consumer Protection Act,” which would prohibit federal banking agencies from requesting or ordering a depository institution to terminate a specific customer account unless there is a material reason to do so that is not based solely on reputation risk. H. R. 766 passed the House on February 4, 2016 by a vote of 250-169.

Broker-Dealer Fiduciary Duty

The FCA includes provisions from H.R. 1090, the “Retail Investor Protection Act,” a measure that would prohibit the Department of Labor (“DOL”) from prescribing rules under the Employee Retirement Income Security Act (“ERISA”) of 1974 defining the circumstances under which an individual is considered a fiduciary until 60 days after the Securities and Exchange Commission (“SEC”) issues a final fiduciary rule governing standards of conduct for brokers and dealers.

Importantly, this section of the FCA would block the final rule issued by the DOL on the definition of a fiduciary under ERISA.

Repealing Volcker Rule

The FCA would repeal Dodd-Frank’s Volcker Rule restrictions on proprietary trading. The Volcker Rule generally prohibits banks from engaging in proprietary trading or sponsoring or owning an equity interest in a hedge fund or private equity fund. The Volcker Rule applies to insured depository institutions, their holding companies, companies treated as bank holding companies, and any subsidiary of these companies. It does not apply to qualifying nondepository trust companies. Despite the broad, general prohibition, the Volcker Rule lists numerous activities that, subject to certain conditions, are nonetheless permitted.

Reforming Investor Protection Rules

Dodd-Frank provided the SEC a number of additional enforcement powers, including the ability to issue rules restricting or prohibiting mandatory pre-dispute arbitration clauses in agreements with customers. The FCA would promote greater transparency and accountability regarding the civil enforcement process and would impose additional penalties for financial fraud and self-dealing. In addition, it would allow the SEC to triple the monetary fines sought in administrative and civil actions in cases where the parties are linked to a defendant’s unlawful profits. The FCA would provide the SEC greater authority to impose sanctions equal to investor losses involving “fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement” in cases where there is a significant loss or risk of loss. Moreover, it would increase the maximum criminal fines for individuals and firms that engage in insider trading and other unlawful conduct.

The Financial CHOICE Act; Dodd-Frank Reform (Not Repeal)

Mortgage Reform and Anti-Predatory Lending

The FCA includes provisions from H.R. 1210, the “Portfolio Lending and Mortgage Access Act,” a measure that would amend the Truth in Lending Act provisions related to mortgage lending known as the “Qualified Mortgage” (“QM”) rule to create a safe harbor from lawsuits for depository institution lenders and the banking regulators, which are required to treat such a loan as a qualified mortgage if the depository institution lender has held it on its balance sheet since origination. Known as the “QM for portfolio loans” this provision permits depository institutions of any size to make mortgage loans that have product features, such as balloon payments, or underwriting characteristics, such as higher debt-to-income ratios, that are otherwise not permitted under Dodd-Frank’s “Ability to Repay” requirements enacted through CFPB regulations.

Dodd-Frank established minimum national standards to require lenders to ensure that a borrower is able to repay a home loan at the time the loan is made. A lender may presume that a borrower will be able to repay a loan if the loan has certain low-risk characteristics that meet the definition of a “qualified mortgage” in accordance with the applicable rules.

Replacing Orderly Liquidation Authority with Bankruptcy Provisions

The FCA would replace the Orderly Liquidation Authority (“OLA”) with a new chapter of the Bankruptcy Code to accommodate large, complex financial institutions. The OLA and its “living wills” requirement have been criticized as an additional regulatory burden for banks. Many have also questioned the OLA’s ability to effectively execute the wind down of a large, complex financial institution.

Dodd-Frank established an OLA for winding down “covered financial companies.” Under these provisions, the Secretary of the Treasury, upon a written recommendation approved by a two-thirds vote of the boards of both the Federal Reserve and the Federal Deposit Insurance Corporation (“FDIC”), may decide to appoint the FDIC as a receiver for a financial company that is in danger of a default that would have a systemically significant impact.

Repealing FSOC’s Payment Clearing and Settlement Supervision Authorities

The FCA would repeal the FSOC’s authority to designate financial market utilities (“FMUs”) as systemically important and would repeal all FMU SIFI designations retroactively.

Dodd-Frank authorized the Federal Reserve, in consultation with the FSOC and the “Supervisory Agencies,” to prescribe standards regulating (1) the risk management of systemically important FMUs and (2) systemically important payment, clearing, and settlement activities conducted by financial institutions. Supervisory Agency refers to the federal agency that has primary jurisdiction over the FMU, including the Federal Reserve, the SEC, or the Commodity Futures Trading Commission.

Additional Elements of the FCA

Job Creation and Capital Formation

The FCA includes provisions from two dozen Committee or House-passed capital formation bills, including the following:

The Financial CHOICE Act; Dodd-Frank Reform (Not Repeal)

- H.R. 4168, the “Small Business Capital Formation Enhancement Act,” which would require the SEC to annually review the government-business forum on capital formation. H.R. 4168 passed the House 390-1.
- H.R. 4498, the “Helping Angels Lead our Startups Act,” which would require the SEC to amend Regulation D to allow general solicitation and general advertising presentations to angel investor groups, among other groups. H.R. 4498 passed the House 325-89.
- H.R. 5019, the “Fair Access to Investor Research Act of 2016,” which would direct the SEC to provide a safe harbor for certain publications or distributions of research reports by brokers or dealers distributing securities. H.R. 5019 passed the House 411-6.

Executive Agency Accountability

The FCA would subject all federal financial services regulatory agencies to the provisions of H.R. 427, the “Regulations From the Executive in Need of Scrutiny Act” (REINS Act), a House-passed bill that would give Congress additional oversight regarding agency regulations and spending. The FCA would make all financial services regulatory agencies subject to bipartisan commissions and to the congressional appropriations process.

The FCA would also require that all financial services regulatory agencies conduct detailed cost-benefit analyses of all proposed rules. It also proposes to reauthorize the SEC for five years with certain funding, structural, and enforcement changes. The FCA also includes a number of administrative due process reforms.

The FCA would repeal the Chevron deference doctrine of administrative law that generally requires courts to defer to agency interpretations of statutes. In addition, the FCA includes provisions of the House-passed H.R. 3189, the “Fed Oversight Reform and Modernization Act” (FORM Act), to increase transparency and accountability regarding Federal Reserve monetary policymaking and regulatory activity. Finally, the FCA would abolish the Office of Financial Research.

Conclusion

In Dodd-Frank, Congress revisited every major federal financial services law, from the National Bank Act of 1864 through the Sarbanes-Oxley Act of 2002. This Herculean effort was accomplished over a very short 14-month period, largely as proposed by the U.S. Treasury, and necessarily entrusting the regulators with unprecedented discretion. Many of the most controversial provisions were added during the House-Senate Conference Committee without any hearing, mark-up, or other legislative history. Consequently, even the primary authors of Dodd-Frank, then-Senate Banking Committee Chairman Chris Dodd (D-CT) and then-House Financial Services Committee Chairman Barney Frank (D-MA) have publicly stated that revisions of the law will be needed.

Given Dodd-Frank’s broad reach, the law will undoubtedly be subject to ongoing revision over many years. Chairman Hensarling’s FCA represents a significant effort to reform Dodd-Frank. Although the proposal is not expected to advance as stand-alone legislation this year, we anticipate that it is likely to inform Dodd-Frank Act reform efforts going forward.

The Financial CHOICE Act; Dodd-Frank Reform (Not Repeal)

Authors:

Daniel F. C. Crowley

dan.crowley@klgates.com
+1.202.778.9447

Bruce J. Heiman

bruce.heiman@klgates.com
+1.202.661.3935

William A. Kirk

william.kirk@klgates.com
+1.202.661.3814

Karishma Shah Page

karishma.page@klgates.com
+1.202.778.9128

Mark A. Roszak

mark.roszak@klgates.com
+1.202.778.9201

Eric A. Love

eric.love@klgates.com
+1.202.778.9415

K&L GATES

Anchorage Austin Beijing Berlin Boston Brisbane Brussels Charleston Charlotte Chicago Dallas Doha Dubai
Fort Worth Frankfurt Harrisburg Hong Kong Houston London Los Angeles Melbourne Miami Milan Newark New York
Orange County Palo Alto Paris Perth Pittsburgh Portland Raleigh Research Triangle Park San Francisco São Paulo Seattle
Seoul Shanghai Singapore Sydney Taipei Tokyo Warsaw Washington, D.C. Wilmington

K&L Gates comprises approximately 2,000 lawyers globally who practice in fully integrated offices located on five continents. The firm represents leading multinational corporations, growth and middle-market companies, capital markets participants and entrepreneurs in every major industry group as well as public sector entities, educational institutions, philanthropic organizations and individuals. For more information about K&L Gates or its locations, practices and registrations, visit www.klgates.com.

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

© 2016 K&L Gates LLP. All Rights Reserved.