

Reform or recalibration?

In the absence of legislative proposals from the Trump Administration, the US Congress looks to roll back Dodd-Frank. But while any dramatic changes are unlikely, the sector will have to implement a number of changes

1 MINUTE READ

The newly-released update of the Financial CHOICE Act has sparked partisan debate about both the value of the act and the underlying causes behind the financial crisis.

The CHOICE Act would repeal parts of the Dodd-Frank Act, including the Volcker Rule and title II, the Durbin Amendment relating to price controls on debit card interchange fees, as well as the Department of Labor's fiduciary rule.

It is likely not the only path for financial services reform as other bills have been introduced in the Senate in prior sessions of Congress. But it is so far the most wide-ranging and comprehensive one.

In the last session of the US Congress in mid-2016, representative Jeb Hensarling first introduced the Financial CHOICE (Creating Hope and Opportunity for Investors, Consumers, and Entrepreneurs) Act. This represented an amalgamation of new proposals as well as numerous individual measures that had been introduced in Congress, as a comprehensive deregulatory bill. The Financial CHOICE Act failed to advance much beyond the Financial Services Committee of the House of Representatives in 2016. Given the new presidential administration's deregulatory agenda, it has been anticipated that new legislation would be introduced to carry forward campaign commitments to repeal the Dodd-Frank Act. However, thus far, from the administration itself there have been only various presidential orders, such as the executive order relating to the core principles for regulating the United States financial system (order 13772), which addresses the principles pursuant to which effective financial services regulation should be evaluated for potential amendment or repeal. To fill the breach, representative Hensarling introduced a new version of the Financial CHOICE Act, referred to as CHOICE 2.0, in the House of Representatives – this was recently adopted by the House Financial Services Committee. While it is unlikely, given the many disparate measures that comprise the draft of the proposed legislation, that CHOICE 2.0 will be enacted in its current form, it is worth reviewing the principal provisions and the measures that might find broad support.

Overview of the CHOICE Act

Like the predecessor bill, CHOICE 2.0 covers a lot of ground by addressing elements of the Dodd-Frank Act, adopting amendments intended to promote capital formation, and limiting the independence of various government agencies, by, among other things, requiring significant changes to the cost-benefit assessments required prior to adoption of new regulations.

The Dodd-Frank Act related provisions

The CHOICE Act would repeal the Volcker Rule, the Durbin Amendment relating to price controls on debit card interchange fees, as

well as the Department of Labor's (DoL) fiduciary rule. The DoL would be prohibited from adopting a fiduciary rule unless the Securities and Exchange Commission (SEC) were to adopt a fiduciary standard for broker-dealers, and, in such case, the rules adopted by the two agencies would have to be substantially similar.

The CHOICE Act also would repeal title II of the Dodd-Frank Act, which provides for the orderly resolution of systemically important financial institutions and replace it with amendments to the Bankruptcy Code designed to address complex financial institutions. In addition, the Federal Deposit Insurance Corporation (FDIC) would be relieved of responsibility for any resolution planning review. Immediately after the financial crisis, the US, together with the other members of the G20 agreed to undertake certain measures to prevent future financial crises, of which orderly resolution of systemically important entities was a cornerstone. The CHOICE Act would repeal the authority of the Financial Stability Oversight Council (FSOC) which is tasked with designating institutions as systemically important. The legislation would repeal title VIII of the Dodd-Frank Act pursuant to which the FSOC designates financial market utilities including payment and clearing systems, as systemically important.

The CHOICE Act addresses the concerns expressed by many commentators that the Dodd-Frank Act is over-broad and takes a one-size fits all approach to bank regulation by proposing regulatory relief for qualifying banking organisations that opt to avail themselves of off ramp provisions. To the extent that a bank maintains an average total leverage ratio of 10% or more, including, for larger institutions, off-balance sheet exposures, the qualifying banking organisation would be relieved of compliance with Basel III regulatory capital requirements, liquidity requirements, living will requirements, the enhanced prudential standards, stress tests, and several limitations on merger activities. Banks not eligible for the off ramp would nevertheless benefit from more relaxed stress test requirements.

The CHOICE Act would rename the Consumer Financial Protection Bureau (CFPB) as the Consumer Law Enforcement Agency – an executive agency outside of the Federal Reserve System led by a single director appointed by, and subject to at-will removal by, the US president. The agency's authority would be circumscribed as it would no longer be able to bring actions relating to unfair, deceptive, or

abusive acts or practices; would have no supervisory or examination authority; would eliminate its enforcement authority over insured depositories; and would have no authority with respect to payday, small dollar and similar loans. In connection with any proposed new regulations, the agency would have to conduct a rigorous cost-benefit analysis that takes into account the impact on consumer price, choice and access of any measure.

Executive compensation-related provisions of the Dodd-Frank Act, such as the pay ratio, hedging, incentive compensation and clawback provisions, as well as the specialised disclosure requirements, would be repealed. Various Dodd-Frank Act provisions relating to credit rating agencies would be modified in an effort to remove barriers to entry.

Capital formation measures

The CHOICE Act incorporates provisions from various standalone bills that are designed to promote capital formation by relaxing the burdens associated with becoming a US public company, and that would extend Jumpstart Our Business Startups (Jobs) Act-related accommodations to more companies. For example, the CHOICE Act would:

- make changes to certain provisions of the Investment Company Act in order to repeal certain registration and reporting requirements for private fund advisers;
- relax the threshold for additional disclosure requirements for stock-based compensation grants under rule 701 of the Securities Act, for private companies;
- modernise section 12(g) registration requirements under the Securities Exchange Act for smaller companies by eliminating the requirement to verify annually accredited investor status and increasing the revenue and shareholder thresholds;
- reform the initial public offering (IPO) process by permitting all issuers, not just emerging growth companies (a category established by the Jobs Act) to benefit from the ability to submit their IPO registration statements to the SEC on a confidential basis and to test the waters to assess investor interest.
- enable a national securities exchange to elect to be treated as a venture exchange to encourage smaller company IPOs;
- reduce the burdens for smaller public companies by expanding eligibility for use of the short-form, or shelf, registration to more companies, providing relief to more

companies from the requirements under section 404(b) of the Sarbanes-Oxley Act for auditor attestation of an issuer's internal control over financial reporting, and relieving certain issuers from the Extensible Business Reporting Language requirements for financial statements and other periodic reporting;

- amend various provisions of the securities laws relating to exempt offerings – for example, by broadening the statutory exemption under section 4(a)(7) of the Securities Act for the resale of restricted securities, modifying the definition of accredited investor, revising the prohibitions against general solicitation, establishing a safe harbour under the Securities Act for certain micro offerings, and amending the regulations applicable to crowdfunding offerings; and
- establish a streamlined process pursuant to which the SEC would evaluate new products, like exchange-traded funds.

Limits on agency authority

The CHOICE Act is expected to limit the authority of all federal financial regulators, incorporating the provisions of various predecessor bills, including the Regulations from the Executive in Need of Scrutiny Act (Reins Act), by changing the appropriations process, establishing a new standard relating to cost-benefit analysis and implementing structural reforms. These measures would have their most significant effects on the authority of the Federal Reserve and the SEC. The Federal Reserve's authority to supervise and issue regulations relating to nonbank financial companies would be repealed. The Federal Reserve's authority would be repealed with respect to certain measures applicable to the enhanced prudential standards, measures affecting qualifying banking organisations, measures limiting further the Federal Reserve's emergency lending powers, and measures that could have the effect of limiting certain aspects of the Federal Reserve's discretion with respect to monetary policy. The act would subject the new Consumer Law Enforcement Agency, the FDIC, the Office of the Comptroller of the Currency (OCC) and the National Credit Union Administration (NCUA) to the congressional appropriations process.

The agency rulemaking process for the Federal Reserve, OCC, FDIC, SEC, Commodity Futures Trading Commission, NCUA and the Federal Housing Finance

Agency would be revised to require that all preliminary and final factual determinations be based on certain evidence. A federal agency would be required to consider, among other factors: the legal authority under which a rule may be proposed, the specific nature and significance of the problem the rule addresses, and any reasonable alternatives. Rulemaking notice requirements would be revised to require agencies to, among other things:

- publish in the Federal Register advance notice of proposed rulemaking involving a major or high-impact rule;
- hold a hearing before the adoption of any high-impact rule; and
- provide interested persons with an opportunity to participate in the rule-making process.

The CHOICE Act also would limit the SEC's enforcement authority by:

- repealing the SEC's authority to bar individuals from serving as officers and directors by administrative action;
- requiring that the SEC determine before imposing civil penalties on an issuer whether the issuer directly benefited from the alleged securities violation and whether the penalty would harm the issuer's shareholders;
- establishing a committee, the Wells Committee 2.0, to evaluate the SEC's enforcement policies and practices;
- requiring enforcement coordination among all financial regulators to minimise duplication;
- prohibiting rulemaking by enforcement; and
- repealing the so-called Chevron doctrine of judicial deference to the interpretations of the SEC and other federal agencies.

Possible areas of consensus and compromise

The CHOICE Act likely is not the only path for financial services reform. There have been other bills introduced in the Senate in prior sessions of Congress that are designed to roll back many of the more controversial provisions of the Dodd-Frank Act. Also, several of the president's executive orders require that the federal agencies identify existing regulations, which, based on the core principles for financial services regulation, ought to be re-evaluated, amended, or repealed. Trade groups have already begun to offer their assessments and recommendations regarding changes to existing regulations that ought to be made in order for such regulations to meet the standards articulated in the president's executive

orders. Regulatory reform officers within the federal agencies must deliver their reports this summer, and these might form the basis for the administration's plan to dismantle the Dodd-Frank Act. The hearings and debate relating to the CHOICE Act were predictably divided along party lines but proved informative because they identified areas where consensus may be within reach. This is especially true if sections of the CHOICE Act were to be presented as standalone bills for consideration. We would include the following within this category:

Capital formation measures

Many, if not most, of the provisions of the CHOICE Act relating to capital formation, including provisions extending the benefit of the Jobs Act to more companies, and easing burdens for smaller companies are likely to have considerable support. Particularly in light of the intense focus on the need to reinvigorate the US IPO market, the measures that are intended to reduce the burdens on US SEC-reporting companies are also likely to receive support, provided that investor protections are not seen as weakened. With a new SEC chair now in place, it is possible that the SEC may take action on other measures, like its disclosure effectiveness initiative, that are intended to streamline and modernise corporate disclosures.

Executive compensation and related Dodd-Frank Act provisions

Several of the specialised disclosure provisions slated for repeal already have faced court challenges and are being revisited by the SEC. Thus, it is likely that many will not survive. Also, various measures identified for repeal in the CHOICE Act were the subject of proposed, not yet final, rules, like the measures related to incentive compensation. In light of the current political climate, it is likely that many measures still in the proposed category will never be finalised.

Stress tests

Even before the new administration was in place, the banking agencies had already begun to review and revisit elements of the stress test requirements. There is consensus that it may be appropriate to continue to make changes to these requirements.

Regulatory relief for smaller banks

There is bipartisan support for measures that would relieve regulatory burdens on community and smaller regional banks, although the off ramp provisions are unlikely to be the path forward toward accomplishing this.

Systemic designation

There is some consensus regarding the need to revisit the process for designating financial institutions, especially nonbank financial institutions, as systemically significant.

Volcker rule

Following publication of various studies, including a research study undertaken by the Federal Reserve, there is some consensus regarding the need to assess the effects of the rule on liquidity and market making. A full repeal of the rule is unlikely.

CFPB reforms

Any Dodd-Frank rollback will involve some restructuring of the CFPB, and limitations on the scope of the Bureau's supervisory and oversight authority.

Finally, both democratic and republican administrations for many years now have sought to bring more rigour to the cost-benefit analysis required in connection with the assessment of proposed, and the re-evaluation of existing, regulations. While it is unlikely that we will see the dramatic changes in agency structure, appropriations, and enforcement powers outlined in the CHOICE Act, it is likely that any regulatory reform measure will recalibrate the cost-benefit and economic analysis required in connection with new regulations.



Oliver Ireland
Partner
Morrison & Foerster
(Washington DC)



Anna Pinedo
Partner
Morrison & Foerster (New York)