Our take: PwC FS update

Change remains a constant in FS risk & regulation. Here’s “our take” on key developments impacting the industry.

7.24.20 Topics: CFTC * OCC * NYDFS * Crypto * Crisis * On our radar

1. CFTC completes derivatives rules

This week, the CFTC finalized (a) capital and reporting requirements for swap dealers (SDs) and major swap participants (MSPs) and (b) a rule that addresses the cross-border application of SD and MSP requirements. Both rules were finalized 3-2 vote with the Democratic commissioners dissenting.

The capital rule allows SDs and MSPs that are not subject to requirements from a banking regulator to choose one of three methods to calculate the amount of capital they will be required to hold:

1. A net liquid assets method that is similar to the way the SEC’s capital requirements for broker dealers are structured and requires SDs to hold the greater of $20m or 2% of their total uncleared margin (down from 8% in the most recent 2016 proposal)
2. A bank-based method that combines percentages of risk weighted assets, tier 1 common equity, and uncleared swap margin
3. A tangible net worth method intended for SDs that are part of a larger non-financial enterprise

The associated reporting requirements require SDs and MSPs to provide financial statements and reports to the CFTC and National Futures Association (NFA) as well as alert the CFTC of issues such as undercapitalization or a failure to post required margin.

The final cross border framework clarifies which swap transactions involving non-US parties are subject to CFTC oversight and when foreign firms need to register with the agency. The new framework excludes certain situations that previously fell within the CFTC’s purview, such as trades booked overseas between foreign affiliates of US parent companies. It also clarifies that trades between two non-US parties will not draw CFTC scrutiny if they are handled by employees based in the US.

Our take

Ten years to the week after the Dodd-Frank Act was signed into law, the CFTC’s required derivatives rulemakings are finally complete. The nature of these two final rules reflects the evolution of the CFTC over the last decade from taking an assertive and far-reaching stance on derivatives oversight to a more accommodating approach that is more aligned with peer and global regulators. The finalized cross-border framework in particular recognizes the authority of foreign authorities and retreats from what some saw as the CFTC acting as the world’s derivatives authority. It is a victory for US banks with large networks of foreign SD entities that will now be much less likely to fall under the CFTC’s purview when trading with other non-US counterparties.

Similarly, the final capital rule also closely aligns with requirements from other regulators. The reduction from an 8% multiplier to the 2% SEC standard for broker-dealers can be considered a win for the industry relative to the 2016 proposal, but many consider it to still be too onerous and potentially counterproductive. For example, broker-dealers collected large amounts of margin from customers during recent market volatility, which then increased their capital requirements. That said, the final requirements are unlikely to be rolled back further at this stage and firms should be preparing for compliance along with working on the securities-based swap rules coming into effect next year.
2. OCC clarifies “true lender” for fintech-bank partnerships

On Monday, the OCC proposed a rule to clarify the “true lender” for loans made by partnerships between fintechs and national banks, specifically providing that a bank is the true lender if, on the date of origination, it 1) is listed as the lender on the loan application or 2) provides the funding for the loan. In May, the agency finalized a rule codifying the “valid-when-made” principle, which allows nationally chartered banks to transfer loans to other banks and nonbanks such as fintechs even if state interest rate caps would prohibit the transferee from issuing the loan. However, that rule left open the question as to which organization is deemed the “lender” in bank partnerships, with some critics expressing concerns that nonbank lenders could simply use their bank partners as cover in order to avoid state requirements. Earlier this year, a group of 22 state attorneys general and a group of consumer groups sent letters to the OCC urging the agency to reconsider the rule.

Banks that are true lenders in fintech-bank lending partnerships will be subject to the full suite of federal regulatory requirements and will be expected to follow the OCC’s expectations for safety and soundness as well as ensure that the loans are not unfair, deceptive or abusive. If fintechs are deemed to be the true lender, they will be subject to federal third party risk management requirements and applicable state law.

Our take

In an interview last month, OCC Acting Comptroller Brian Brooks explained that the “true lender” rule would contain bright line criteria to determine when fintech-bank lending partnerships are merely “rent-a-chartering” used to avoid state interest caps. However, by allowing partnerships to essentially choose which entity is the true lender by simply listing their name in the loan application, the proposal appears to be more of a removal of obstacles than an addition of guardrails. Fintech lenders will welcome this straightforward clarification as it provides an attractive path to partner with national banks and avoid complex state-by-state regulations, but they should not start celebrating just yet. Considering the opposition from states and consumer groups, the rule and “true lender” definition may be subject to a long legal battle. Both could also get reversed or scaled back by future leadership, especially with an election later this year and Brooks’ status as Acting Comptroller.

3. NYDFS announces first cyber enforcement action

On Wednesday, the New York Department of Financial Services (NYDFS) announced charges against an insurance company related to alleged defects in its cybersecurity program. Specifically, the NYDFS alleged that the company’s website contained a defect that left it vulnerable to potential bad actors manipulating its URL in order to retrieve sensitive customer data such as bank account information and social security numbers. While the announcement does not cite a specific breach, it notes that management failed to address the vulnerability for six months after it was discovered, ignored recommendations from its cybersecurity team and misclassified the vulnerability as “low.”

This is the first enforcement action announced under NYDFS’s cybersecurity regulation (i.e., Part 500), which contains a broad set of cybersecurity expectations for financial institutions, including requirements around encryption, multi-factor authentication, governance, and reporting.

Our take

The wait for NYDFS cyber enforcement is over. Since assuming leadership of the agency last year, Superintendent Linda Lacewell, herself a former federal prosecutor, has reorganized the agency with a focus on enforcement and filled key roles with other prosecutors. Absent is the allegation of large-scale data loss; present is the citation of risk management shortcomings - showing that the agency is not going to wait until a data breach to react but instead expects that firms take a proactive approach to assess and mitigate risk. While the matter is not yet settled - the action is scheduled for a public administrative hearing before NYDFS in October - the message is clear: New York cybersecurity enforcement means business.
4. OCC to allow banks to offer cryptocurrency custody services

On Wednesday, the OCC published a letter clarifying that national banks and federal savings associations can provide custody services for cryptocurrency. Currently, such services are provided by specialist firms that require state-by-state licenses to conduct business. While no law explicitly prohibited banks from providing these services, no bank offered them due to regulatory uncertainty. The letter reminds banks that, like all other activities, their crypto custody services should be subject to appropriate risk management policies and procedures.

This is the latest step in recent regulatory actions that could potentially increase access to cryptocurrency and related services. Last month, NYDFS proposed a framework for licensing various crypto firms and released a set of FAQs around license applications. It also recently released guidance to ease the process for listing new digital assets.

**Our take**

Crypto, once the sole purview of state regulators, now has a federal option. Since Brian Brooks, former general counsel to a large cryptocurrency exchange and custodian, began his tenure as Acting Comptroller, he has been focused on removing regulatory obstacles for crypto and other digital assets. By interpreting custody as a safekeeping service, he has continued this focus in a manner complementary to similar interpretations by states of their own banking laws. While states have recently sued to block the OCC’s proposed fintech charter, permitting existing national banks to expand their services is more difficult to challenge. State regulators may even welcome this interpretation as many states such as New York have explicit “wildcard statutes” authorizing regulators to permit state-chartered banks to exercise powers available to corresponding federally-chartered institutions but not expressly authorized by state banking laws. As a result, by opening the door to national bank custody of crypto, the OCC may have given that option to state regulators and state-chartered banks as well.

5. Agencies offer relief and flexibility for crisis management

This week, the financial services regulatory agencies have continued to take actions to support the economy and markets in response to heightened volatility and uncertainty. Specifically:

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<th>Entity</th>
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<td>FRBNY</td>
<td>The Federal Reserve Bank of New York (FRBNY) announced that it is looking to expand eligibility criteria for counterparties and agents for the Commercial Paper Funding Facility (CPFF), the Secondary Market Corporate Credit Facility (SMCCF) and the Term Asset-Backed Securities Loan Facility (TALF). Specific eligibility requirements are described in a new expression of interest form and FAQs.</td>
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<td>FRBB</td>
<td>The Federal Reserve Bank of Boston (FRBB) released FAQs on nonprofit lending for the MSLP.</td>
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<td>FRBNY</td>
<td>The FRBNY announced that $983m in loans were requested for the July 21 TALF subscription date. In terms of sectors, the volume of commercial mortgage and small business-backed loans is consistent with the previous subscription date while the volume of those backed by student loans increased by $192b.</td>
<td>7/21</td>
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<td>FRBNY</td>
<td>The FRBNY announced that it will hold a technical briefing on the Primary Market Corporate Credit Facility (PMCCF) on July 31 targeted towards underwriters and issuers interested in transacting with the facility.</td>
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Our take

This relatively quiet week on the crisis management front saw Congressional Republicans actively negotiating their version of the next relief bill. They are expected to unveil their proposal early next week before diving into negotiations to find a middle ground with the $3t bill House Democrats passed two months ago. Millions of Americans will receive their last expanded unemployment check this week while new unemployment claims increased for the first time in months last week, adding to the pressure for Congress to reach a quick compromise.

6. On our radar: These notable developments hit our radar this week:

1. **LIBOR transition: ARRC publishes recommendations for syndicated loans.** On Wednesday, the Alternative Reference Rates Committee (ARRC) released recommended conventions for the use of the Secured Overnight Financing Rate (SOFR), its recommended alternative to USD LIBOR, in syndicated business loans. Rather than converging on a single recommended methodology, the guidance clarifies the implications of basing new SOFR syndicated loans on either simple or compound interest. While the guidance does provide specific recommendations for other conventions, such as business day lookback, observation shifts, day count conventions and rounding, the ARRC provides optionality for market participants. As different firms are bound to make different choices, market participants will likely need to prepare for multiple conventions in cash products. Additional technical reference and market feedback documents in support of the ARRC’s guidance are expected to be published separately.

   Subscribe to PwC’s LIBOR Transition Market Update here to read more about these and other developments.

2. **SEC finalizes proxy rules.** On Wednesday, the SEC voted 3-1 to approve a set of new rules governing proxy voting advice. Under the rules, proxy advisers will be required to disclose their voting recommendations to companies at the same time they send them to clients, provide this disclosure at least 40 days prior to annual meetings and inform their clients of company responses to their recommendations.

3. **FDIC seeks input on fintech certification.** On Monday, the FDIC released a request for information on potential standards and voluntary certification for fintechs that provide services in partnership with banks. Specifically, the FDIC is seeking input on whether the proposed standards and program would eliminate regulatory uncertainty and promote innovation.

4. **States and industry urge federal regulators to take action on climate change.** On Tuesday, state agencies in New York, Maryland, California and Illinois joined with financial firms managing $1 trillion in assets to urge the Fed and other financial regulators to begin examining the risks posed by climate change to “protect the economy from any further disruptive shocks.”

5. **FDIC and SEC finalize broker-dealer orderly liquidation rule.** Today, the FDIC and SEC finalized a rule to clarify and implement procedures for the orderly liquidation of a broker-dealer. The rule was proposed in 2016 and required by the Dodd-Frank Act.

6. **Fed updates CCAR resubmission FAQs.** Today, the Fed released new FAQs on the Comprehensive Capital Analysis and Review (CCAR) resubmission announced last month along with this year’s results. They state that the Fed will release further details on required materials and the “two or three” scenarios it will develop by September 30. The Fed also says it will decide whether to recalculate firms’ stress capital buffers following the resubmission, but notes that “the capital framework emphasizes the value of not increasing capital requirements under stress.”

7. **CFPB to issue ANPR on financial data access.** The CFPB announced today that it will issue an advanced notice of proposed rulemaking (ANPR) on consumer-authorized third-party access to financial records.
Additional information

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