Our Take
PwC's Financial Services Update

Change remains a constant in FS risk & regulation.

5.7.21 Topics: OCC * Fed * SEC * On our radar

1. Michael Hsu appointed Acting Comptroller

Earlier today, the Treasury Department announced that Michael Hsu, currently the Fed's Associate Director of Supervision and Regulation, will become the OCC's Acting Comptroller on May 10. He will replace Blake Paulson, who will remain at the agency as Senior Deputy Comptroller and Chief Operating Officer. Paulson has served as Acting Comptroller since Brian Brooks stepped down from the same position in mid-January of this year.

The previous Administration led the OCC through a number of moves primarily focused on fintech and innovation. Specifically, it finalized the "true lender" rule providing regulatory clarity to bank-fintech lending partnerships (see here for Our Take on the rule), announced its intention to offer special purpose charters to fintech companies, clarified that banks can provide certain cryptocurrency custody services and finalized modernization of the Community Reinvestment Act (CRA). It also proceeded with new charters related to fintech and cryptocurrency, granting the first national banking charter application to a mobile-only fintech, approving a fintech lender's acquisition of a national bank, and conditionally approving a cryptocurrency firm's application to convert its state charter to a national trust charter. Last month, Acting Comptroller Paulson sent a letter to Senate Banking leadership defending the "true lender" rule.

Several days before the announcement, the American Bankers Association released a letter asking the OCC to withdraw or delay the compliance date of its CRA reform rule, citing that many firms have not begun building the technological infrastructure necessary to comply with its new data reporting requirements. The letter also requests that the OCC align its CRA rule with the Fed and FDIC, which released a separate joint proposal late last year.

Our Take

The Comptroller position has turned into one of the more politically contentious nominations for the new Administration with the progressive and moderate wings of the party struggling to reach agreement on potential candidates. By appointing Michael Hsu as Acting Comptroller, the Administration can ensure that it has direct insight and influence over agency operations while the political debate plays out. Recent Acting Comptrollers at the agency, Keith Noreika and especially Brian Brooks, both did not let their "Acting" role slow down their rulemaking, enforcement and charter approval agendas. However, considering that Hsu is a career regulator with a previous relationship working with Treasury Secretary Janet Yellen as opposed to coming from industry, we do not anticipate any controversial actions under his tenure. We do expect Hsu to keep the agency moving at a steady, predictable pace in carrying out the Administration's immediate priorities, likely through coordinated actions with other regulatory agencies and lending a sensitive ear toward Congressional Democrats. This potentially includes joining in efforts on environmental, social and governance (ESG) policies, aligning CRA reform with the Fed and FDIC, and working closely with the CFPB on issues such as consumer fair access and housing initiatives. Other aspects of OCC policy, such as whether and how far it will diverge from the approach former Acting Comptroller Brooks took regarding fintech, cryptocurrency and chartering, may wait for a formally nominated Comptroller. Regardless, we will likely get a first look at the direction that Hsu will be taking the agency in the OCC's Semiannual Risk Perspective slated to come out later this month. Stay tuned.

2. Fed proposes guidelines for fintech access to payment system

On Wednesday, the Fed proposed a series of principles for evaluating applications from "novel institutions" (i.e. recipients of "novel charters" such as fintech companies) to receive access to Reserve Bank account and priced services. Notably, this would include access to the payments system, which would allow them to make and receive payments without using another bank as an intermediary. The accompanying press release explains that the Fed developed the proposal to create a consistent and transparent framework for the evaluation of requests made by a diverse array of new financial service providers. Among other requirements, the proposal provides that only entities that are member banks or accept deposits would be eligible to access Fed accounts and services. While institutions would not need FDIC insurance to qualify, requests from non-federally insured institutions would receive more extensive due diligence. The proposal further outlines that the Fed should consider applicants' ability to comply with requirements around the Bank Secrecy Act / anti-money laundering (BSA/AML), sanctions, and consumer protection. The Fed would also evaluate whether the applicant would present undue credit, operational, settlement, or cyber risks and whether it would present stability risks to the broader financial system. In making this evaluation, the Fed would look into whether the applicant has an effective risk management framework, is in sound financial condition and maintains sufficient liquidity. The proposal notes that the Fed Regional Banks, which would be making these decisions, would rely to the extent possible on assessments made by the applicant's primary state and/or federal supervisor.

The proposed guidelines come as the state of Wyoming's Banking Division recently approved applications for special purpose depository institution charters from digital asset firms, and at least one of those firms has applied to the Kansas City Fed to create a master account, which would provide access to Fed services including the payments system. Comments will be accepted for 60 days following publication in the Federal Register.

Our Take

The timing of the Fed's proposal appears to be a response to some digital asset firms organized as non-insured depository institutions applying for direct access to the payment system. Judging from the proposal, the answer for some of these institutions is "not so fast" as the Fed appears poised to take a careful look as to whether institutions seeking to access the payment system meet the same criteria as banks. While some digital asset firms will appreciate the clarity provided by the proposal, many will have a long way to go to meet its stringent requirements, in particular those around liquidity risk, BSA/AML, and cybersecurity. With this proposal, the Fed is also looking to establish transparent and consistent rules across the entire reserve system as various Fed banks make decisions on applications in the near future. The message from the Fed is clear: "same activity, same regulation" - it will not stand in the way of fintech and crypto firms, but those looking for a level playing field must rise to the same high standards expected from banks.

3. Gensler faces questions from House Financial Services

Yesterday, the House Financial Services Committee (HFSC) held a hearing on recent market volatility including the GameStop trading activity from earlier this year. Among other witnesses, the Committee heard from SEC Chair Gary Gensler in his first time appearing before Congress after his confirmation three weeks ago. In his opening remarks, he explained that the SEC is producing a report on the recent volatility and looking into whether expanded enforcement mechanisms are necessary. He highlighted a number of issues that the agency is focusing on, including gamification of trading, social media communications, transparency around short selling, and whether "payment for order flow" or exchange rebate arrangements violate customer best interest obligations or affect consolidation in the market. Gensler also highlighted that the decisions by some broker-dealers to restrict trading during the GameStop volatility calls into question whether margin and payment requirements are sufficient and whether broker-dealers have appropriate tools to manage their liquidity and risk, noting that he believes that shortening the settlement cycle may reduce some of these risks. In addition, Gensler brought up the recent

Archegos incident and announced that he is directing SEC staff to look into including total return swaps and other security-based swaps under new disclosure requirements (for more on the Archegos incident, see our First Take).

In addition to the stated focus on market volatility, HFSC members took the opportunity to raise a variety of SEC-related issues throughout the hearing. When asked about the SEC's actions around environmental, social and governance (ESG) issues, Gensler clarified that he expects the agency to release a proposed rule on public company climate disclosure as opposed to guidance or another mechanism. Gensler was also asked about the SEC's authority over cryptocurrency and he said those that trade like assets would fall under the agency's jurisdiction. He further indicated that he sees a need for stronger investor protection in the crypto market.

Our Take

The variety of topics addressed in Gensler's first hearing as Chair indicate a very full agenda for the SEC and a strong desire for details of what shape its focus on each of these areas might take. Although the SEC's request for comment on climate disclosure was made under Acting Chair Allison Herren Lee, Gensler's foreshadowing of a climate disclosure rule proposal indicates that he is on board with actions taken by his predecessor - and that enhanced requirements are likely not a matter of if but when. Firms should consider preparing for more forceful requirements by setting clear disclosure objectives; defining key metrics using recommendations from global standard setting organizations; identifying underlying data sources; and embedding climate-related information into their data governance models and management processes.

Regarding the intended focus of the hearing, Gensler's remarks suggest that the SEC is taking the dynamics around both the GameStop and Archegos incidents seriously. This heightened attention means that new guidance or rulemaking around issues such as disclosure of short positions and total return swaps could become a reality - following lengthy study and comment periods. We could also see a liquidity rule for broker-dealers and SEC support for a shortened settlement cycle. Given the controversy around the SEC's previous foray into regulating order flow fees and rebates,[1] we may see this new study on payment for order flow gravitate more towards recommendations for enhanced reporting and disclosure rather than outright banning certain practices. Accordingly, firms should take steps to understand potential investor reactions to greater transparency around their order flow routing and incentives. As the SEC is also studying gamification of trading, firms should also closely review how they encourage or reward trading activity and whether such practices could expose them to conflict of interest requirements.

[1] In June 2020, the DC Court of Appeals ruled that the SEC lacks the authority to order stock exchanges to experiment with trading fees. The case stemmed from the SEC's pilot program intended to limit transaction fees on one group of stocks and prohibit giving rebates to brokers on another in order to collect data for potential future regulation.

4. On our radar: These notable developments hit our radar over the past week:

- **ARRC specifies market indicators that would allow for recommendation of a SOFR term rate.** On Thursday, the Alternative Reference Rates Committee (ARRC) published a set of qualitative indicators it expects to monitor as it is making a decision on the recommendation of a forward-looking SOFR term rate. As SOFR is an overnight rate, broadly reflecting the cost of overnight borrowing collateralized by Treasury securities, the calculation of term SOFR rates is derived from the transacted prices of derivatives indexed to SOFR. The published indicators align to the ARRC's previous declarations that a formal recommendation would depend on robust liquidity in derivative markets underpinning the calculation of SOFR term rates: continued growth in SOFR-based derivatives trading volume, progress in market making of SOFR-based products and continued growth in the offering of cash products tied to SOFR. The ARRC expresses confidence that these indicators would be met as market participants transition from USD LIBOR to SOFR, which could allow the ARRC "to recommend a SOFR-based term rate relatively soon."

  Although the Chicago Mercantile Exchange's (CME) launched their forward-looking SOFR term rate (for limited use in cash products) just over two weeks ago, the ARRC reaffirmed that it has not yet made a recommendation of a SOFR term rate. Such a formal recommendation is important in the context of the ARRC's suggested fallback language for cash products, which stipulates an ARRC recommended term rate as the first replacement option at the point of USD LIBOR's cessation.

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

- **Fed issues financial stability report.** Yesterday, the Fed issued its most recent semiannual Financial Stability Report. The report acknowledges that the financial system has proved resilient to the pandemic but highlights rising valuations, equity indices and investor risk appetites - as indicated by the GameStop volatility and growth in other assets made popular by social media. In a statement released with the report, Governor Lael Brainard raised the Countercyclical Capital Buffer as a potential tool to address risks to financial stability from elevated valuations and risk appetites. The report also highlights the Archegos incident as an example of limited visibility into risks posed by funds.

- **Regulators coming to the Hill.** On May 19, the HFSC will hold an oversight hearing of the prudential regulators. Although the witnesses are not yet listed, they will likely be Fed Vice Chairman for Supervision Randal Quarles, FDIC Chairman Jelena McWilliams, new Acting OCC Comptroller Michael Hsu and NCUA Chairman Rodney Hood. The Senate will also likely hold a similar hearing.

Additional information

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