Client Alert

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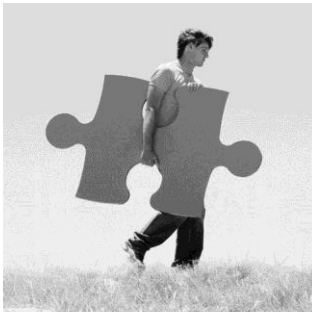

Treasury Report, Part II: Regulation of the Capital Markets

The U.S. Department of the Treasury ("Treasury Department" or "Treasury") issued its second report (of four reports), titled "A Financial System that Creates Economic Opportunities, Capital Markets" (the "Report"). The Report was issued in response to Presidential Order 137772 setting forth the Core Principles that should guide regulation of the U.S. financial system. The Report addresses various elements of the capital markets, from the equity and debt markets, to the U.S. Treasury securities market, and to derivatives and securitization. The Report also addresses the role and regulation of financial market utilities and clearinghouses. Like many movie sequels, which are somehow less compelling than the original, this second installment is less cohesive than the first Treasury report, which focused on the regulation of depositary institutions.[1] The Report notes that certain aspects of the capital markets regulatory framework are working well, but other elements would benefit from better "calibration." To that end, the Report recommends various measures, most of which would not require legislation, that would promote capital formation. There are few novel recommendations included in the Report. Below, we discuss many of the recommendations in the principal areas of interest to our clients.

Capital formation

The Report reviews now-familiar ground, lamenting the decline in the number of U.S. public companies and initial public offerings in the United States in recent years. While noting that it is difficult to isolate the cause for the decline in the number of IPOs, the Report attributes the decline at least in part to increased regulatory burdens facing U.S. public companies. The Report's recommendations are largely consistent with provisions of various standalone bills introduced in Congress this session, many of which have been subsumed into the Financial CHOICE Act. Below, we highlight key recommendations:

- Certain of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") mandate requiring specialized disclosures, such as conflicts minerals disclosures, should be repealed and withdrawn.
- Duplicative, redundant, or outdated disclosures required by Regulation S-K should be modified or eliminated. The Securities and Exchange Commission (the "SEC") is already addressing amendments to Regulation S-K, since the SEC was required to take action in this regard by the FAST Act.
- The SEC should permit all issuers, not only emerging growth companies ("EGCs"), to conduct test-the-waters discussions. A bill was recently introduced in the U.S. House of Representatives that would do just this. The Report also recommends that EGCs be able to retain their status for up to 10 years.
- The SEC should explore a number of options to evaluate the role of proxy advisory firms, including regulation of their activities, and increasing the requirements for shareholder proposals.

[1] Read our client alert on the first Treasury report: https://media2.mofo.com/documents/170613-us-treasury-department-report.pdf.

- States and the SEC should investigate means to reduce the costs of securities litigation.
- The benefits of scaled disclosure should be extended, including by amending the definition of "smaller reporting companies" ("SRCs"). The SEC has already proposed, and is expected to adopt, amendments to the SRC definition.
- The rules and regulations relating to research should be consolidated, evaluated, and harmonized.
- Regulations relating to Tier 2 Regulation A offerings and crowdfunding should be reviewed and revised to allow for more flexibility.
- The efficiencies associated with private capital-raising should be preserved by, among other things, expanding the categories of sophisticated investors included as "accredited investors."

The Report also addresses equity market structure issues, as well as corporate bond market liquidity.

Business Development Companies

Treasury recommends that the SEC revise its securities offering reform rules to permit business development companies ("BDCs") to use streamlined reporting and filing procedures now available to "well-known seasoned issuers." When the SEC reformed securities offering rules in 2005, it excluded BDCs. These rules, among other things, provided:

- a safe harbor for factual business information and forward-looking information;
- expanded communication provisions in connection with registration statement filings; and
- an "access equals delivery" model for prospectus delivery.

Treasury recommends that the SEC allow BDCs to benefit from the same provisions available to other issuers that file Forms 10-K, 10-Q, and 8-K. These recommendations track the provisions of the Financial CHOICE Act.

Interval funds

In an effort to encourage closed-end funds to invest in smaller public companies with less liquid shares, Treasury recommends that the SEC consider loosening restrictions on registered closed-end funds structured as "interval" funds. Unlike mutual funds, which offer daily redemption, closed-end funds offer no daily redemption rights but are often tradable on a secondary market. Exchange-traded closed-end funds, however, frequently trade at a discount to net asset value.

The SEC adopted exemptive rules to create interval funds, which are closed-end funds that allow shareholders to redeem their shares periodically, at certain three-, six-, or 12-month intervals, subject to various conditions and limitations. Treasury recommends that the SEC consider revising the interval fund rules to allow them more flexibility to invest in small-cap, less liquid securities. For example, rather than require redemptions at fixed monthly or quarterly intervals, a rule may tie the ability to redeem to a "liquidity event of a portfolio company," which lessens the risk that an illiquid portfolio holding could affect the right to redeem. This feature would be similar to those available to venture capital funds.

Securitization

The Report generally concludes that securitization is a vital financial tool to facilitate growth in the domestic economy, and that post-crisis regulatory reforms have gone too far toward penalizing securitization relative to alternative funding sources. The result, according to the Report, has been to dampen the attractiveness of securitization, potentially cutting off or raising the cost of credit to thousands of corporate and retail consumers. The Report then describes a number of recommendations for improving the functioning of the securitization market, including:

- Changing bank capital requirements to rationalize the capital required for securitized products with the capital required to hold the same disaggregated underlying assets, such that bank capital requirements neither encourage nor discourage funding through securitization;
- Changing bank capital rules for securitization exposures to account for credit risk transferred, rather than tying the capital requirement to the amount of the securitization trust that is consolidated for accounting purposes;
- Considering changes to bank liquidity requirements to permit higher-quality senior securitized interests to be treated more favorably in counting toward a bank's Liquidity Coverage Ratio ("LCR");
- Expanding the types of "qualifying" assets exempt from the federal credit risk retention requirements imposed on securitization sponsors;
- Reducing the mandatory holding period during which securitization sponsors must retain credit risk exposure to securitized assets;
- Adopting a broad qualified exemption from risk retention requirements for collateralized loan obligation ("CLO") transactions;
- Designating a lead federal agency responsible for future actions relating to the credit risk retention rulemaking;
- Reducing the number of asset-level reporting fields required to be disclosed in SEC-registered securitizations under Regulation AB II;
- Shortening the SEC's mandatory three-day waiting period for offerings of SEC-registered asset-backed securities under Regulation AB II; and
- Signaling that the SEC will not extend Regulation AB II disclosure requirements to 144A offerings or to additional securitized asset classes.

Derivatives

Treasury notes a broad consensus in favor of the primary derivatives market reforms of Title VII of Dodd-Frank. However, the Report notes significant issues and makes substantial recommendations to implement Title VII in a manner less burdensome to market participants and to the U.S. derivatives market as a whole. The derivatives-related issues that the Report identifies relate to regulatory harmonization, cross-border matters, capital treatment of derivatives, end-user issues, and market infrastructure.

Regulatory Harmonization

The Report notes significant differences between the Commodity Futures Trading Commission's ("CFTC") rules for swaps and the SEC's rules for security-based swaps and, in certain cases, significant differences between U.S. rules and the rules of non-U.S. authorities.

Treasury's recommendations in connection with harmonization include the following:

- The CFTC and the SEC should give high priority to a joint effort to review their respective rulemakings in each key Title VII reform area, the goal of which should be to harmonize rules to the fullest extent possible; and
- The CFTC should simplify and formalize its outstanding no-action relief that forms part of its Dodd-Frank swaps regulatory framework, including, where necessary and appropriate, amendments to the CFTC final rules.

In relation to the harmonization of margin requirements for uncleared swaps, Treasury recommends that:

- the U.S. banking agencies consider providing an exemption from margin requirements for interaffiliate transactions similar to the exemptions contained in the CFTC and non-U.S. rules;
- the U.S. regulators consider amending their rules to conform to non-U.S. rules that permit more time for transfers of required margin;
- the CFTC and the prudential banking regulators reconsider treatment of financial end users for purposes of margin, and tailor their requirements to focus on the most significant risks; and
- the SEC, which has not yet finalized its margin rules, repropose those rules to align them with the margin rules of the CFTC and the prudential banking regulators.

Cross-Border Matters

In connection with the cross-border application of U.S. rules, Treasury recommends that the CFTC and SEC clarify the cross-border reach of their regulations and harmonize their rules with those of non-U.S. jurisdictions, where possible, to avoid market fragmentation, redundancies, undue complexity, and conflicts of law. More specifically, Treasury recommends that U.S. regulators:

- consider whether swap counterparties, trading platforms, and central counterparties in jurisdictions compliant with international standards should be required to register with the CFTC or the SEC as a result of doing business with a U.S. firm's foreign branch or affiliate;
- be judicious when applying their swaps rules to activities outside the United States and permit entities, to the maximum extent practicable, to comply with comparable non-U.S. derivatives regulations, in lieu of complying with U.S. regulations; and
- reconsider the implications of applying Title VII rules to so-called "ANE" transactions, whose primary connection with the U.S. is that they are "arranged, negotiated, or executed" by personnel located in the U.S.

Capital Treatment

The Report notes several issues relating to the capital treatment of centrally cleared derivatives. These include the imposition of significant capital requirements on initial margins by means of the supplementary leverage ratio ("SLR") and the resulting higher capital charges incurred in connection with the activities of futures commission merchants ("FCMs"), which discourage FCMs from clearing derivatives transactions for clients.

Treasury recommends that regulators balance the post-crisis goal of moving more derivatives into central clearing with appropriately tailored and targeted capital requirements, and that they adopt recommendations contained in Treasury's previous banking report, which would soften the application of the SLR to centrally cleared derivatives.

End-User Issues

In connection with issues facing end users of derivatives, Treasury recommends that the CFTC:

- maintain the swap dealer *de minimis* registration threshold at $8 billion, and make clear that any future changes to the threshold will be subject to a formal rulemaking and public comment process; and
- complete its position limit rules, with a focus on detecting and deterring market manipulation and other fraudulent behavior.

Market Infrastructure

In relation to market infrastructure, Treasury recommends that the CFTC:

- consider rule changes to permit swap execution facilities ("SEFs") to execute swaps that are subject to the trade execution requirement by methods in addition to the currently permitted order book method and request for quote method; and
- re-evaluate the process by which swaps are "made available to trade" on SEFs to ensure that all swaps that are subject to the execution requirement trade with sufficient liquidity.

Treasury also states its support of the CFTC's "Roadmap to Achieve High Quality Swaps Data" announced in July 2017 and intended to help standardize reporting fields, harmonize data elements and technical specifications with those of other regulators, and improve data validation and quality control processes.

Financial Market Utilities

In contrast to other sections that generally call for more streamlined regulation and reduced regulatory burden, the Report recommends heightened regulation of financial market utilities ("FMUs"). FMUs are multilateral systems that provide the infrastructure for the transferring, clearing, and settling of payments, securities, derivatives, and other financial transactions. The Financial Stability Oversight Council may designate FMUs as systemically important FMUs ("SIFMUs") under Title VIII of Dodd-Frank. The Report notes that there are eight SIFMUs, and also discusses a ninth FMU that has not been designated as a SIFMU.[2]

The Report finds that certain FMUs are highly interconnected to other U.S. financial institutions, and facilitate significant transaction volumes and values. It notes that risk concentrations in some FMUs have risen dramatically following the passage of Dodd-Frank, which, among other things requires mandatory clearing of certain derivatives by FMUs that are central counterparties ("CCPs"), and that distress at or failure of one of these FMUs could pose systemic risk. However, the Report concludes that the regulatory oversight and resolution regime for these institutions remains insufficient.

Another key concern noted by the Report is that SIFMUs may be authorized to access the Federal Reserve discount window in unusual or exigent circumstances under Dodd-Frank. Citing Presidential Order 137772, the Report warns that the U.S. financial regulatory system must avoid creating moral hazard, so that SIFMUs cannot anticipate the provisioning of emergency liquidity from the Federal Reserve in their risk management planning. While SIFMUs may be authorized to access the discount window in unusual or exigent circumstances under Dodd-Frank, the Report asserts that a SIFMU must first exhaust credible private sources of borrowing.

In order to address these and other issues involving SIFMUs, the Report makes a number of recommendations:

- Given their importance to the financial system and broader economy, SIFMUs should be subject to "heightened regulatory and supervisory scrutiny."
- Changes to the rules, operations, and procedures of SIFMUs that may present material risks need to be closely reviewed by regulators.
- Federal agencies that supervise SIFMUs (the Federal Reserve, CFTC, and SEC) should bolster resources devoted to these reviews; and in particular, additional resources should be allocated to the CFTC to enhance its supervision of FMUs that are CCPs.

[2] These entities include:

- Central counterparties: Chicago Mercantile Exchange, Inc.'s (CME, Inc.) CME Clearing division; Depository Trust and Clearing Corporation's (DTCC) Fixed Income Clearing Corporation and the National Securities Clearing Corporation; Intercontinental Exchange, Inc.'s ICE Clear Credit LLC; and LCH, Ltd., the only FMU discussed that is not a SIFMU; and the Options Clearing Corporation;
- Central securities depository (Depository Trust Company); and
- Payment and settlement systems (CLS Bank International and The Clearing House Payments Company, L.L.C.).

- The agencies should study how to streamline their existing review processes to be more efficient and appropriately tailored to the risk that a particular SIFMU's rules may pose.

In addition, noting that Dodd-Frank provides that the Federal Reserve may authorize the Federal Reserve Banks to establish and maintain central bank accounts for, and services to, each SIFMU, the Report recommends that the Federal Reserve review what risks may be posed to U.S. financial stability by the lack of Federal Reserve Bank deposit account access for certain FMUs with significant shares of U.S. clearing business, and an appropriate way to address any such risks; and whether the rate of interest paid on SIFMUs' deposits at the Federal Reserve Banks may be adjusted based on a market-based evaluation of comparable private sector opportunities.

The Report also discusses the resilience, recovery, and resolution of CCPs. Resilience refers to the ability of a central counterparty to withstand clearing member failures and other market stress events. Recovery is the ability of a CCP to continue to provide services to markets following a stress event without the direct intervention of a public sector resolution authority. Resolution is what occurs when recovery is unachievable through either bankruptcy or Title II of Dodd-Frank.

With regard to resilience, the Report notes that the CFTC's supervisory stress tests of five registered derivatives clearing organizations ("DCOs") conducted in 2016 was an important first step in promoting resilience of CCPs. However, the Report states that this exercise focused only on credit risk relating to the default of a clearing member, and recommends that future exercises incorporate additional products, different stress scenarios, liquidity risk, and operational and cyber risks, which can also pose potential risks to U.S. financial stability.

With regard to recovery and resolution, the Report states that the primary regulatory focus must be the recovery (as opposed to the resolution) of the CCP, such that the CCP can continue to provide critical services to financial markets, and ensuring that the matched book of the failing CCP can be preserved. The Report encourages the CFTC and the FDIC, which would be the responsible resolution authority if a SIFMU were resolved under Title II of Dodd-Frank, to continue to coordinate on the development of viable recovery wind-down plans for CCPs that are SIFMUs. While the Report notes that there have been efforts by regulators and market participants to prepare for the default of large clearing members, it states that there may also be instances in which a CCP experiences significant nondefault losses, such as operational or business failures, including cyber, custodial failures, or investment losses. In light of these significant nondefault-type losses, the Report recommends that U.S. regulators, in coordination with their international counterparts, focus additional recovery and resolution planning efforts on nondefault scenarios. In addition, the Report recommends that U.S. regulators continue to take part in various groups, including Crisis Management Groups and international bodies such as the Financial Stability Board and CPMI-IOSCO, to share relevant data and consider the coordination challenges that domestic and foreign regulators may encounter during cross-border resolution of CCPs.

Regulatory structure and process

The Report notes that there has been increasing overlap between the regulation of U.S. securities markets subject to SEC jurisdiction, and derivatives markets subject to CFTC jurisdiction, as financial products and the market participants and intermediaries who trade them have converged. However, the Report does not recommend a merger of the two agencies, concluding that budgetary and regulatory efficiencies from such a merger would be limited.

Instead, in order to better manage regulatory overlap and improve regulatory processes, the Report recommends that the SEC and CFTC continue their joint outcomes-based efforts to harmonize their respective rules and requirements. It also recommends that Congress restore the CFTC's and SEC's full exemptive authority and remove restrictions on those authorities imposed by Dodd-Frank, which limited the agencies' ability to grant appropriate exemptions in certain circumstances.

In addition, the Report makes a number of recommendations to improve regulatory processes at the two agencies, including:

- more enhanced economic cost-benefit analysis of rulemakings;
- greater rulemaking transparency through the use of advance notices;
- greater consideration of the effects on small entities; and
- regular reviews of agency rules for burden, relevance, and other factors.

The Report acknowledges and supports the CFTC's Project KISS (for "Keep it Simple, Stupid") initiated this year to conduct an internal review of CFTC rules and practices to identify areas that can be made less burdensome and costly, and generally supports principles-based regulation to the extent appropriate and consistent with applicable law.

The Report further recommends that the CFTC and SEC avoid imposing new requirements by no-action letter, interpretation, or other forms of guidance, that often had been used by the CFTC in particular to implement Title VII of Dodd-Frank in order to meet short statutory deadlines, rather than through notice-and-comment rulemaking. The Report states that the agencies should also review existing guidance and revisit any that have caused market confusion or compliance challenges.

Finally, the Report recommends that both agencies conduct comprehensive reviews of the roles, responsibilities, and capabilities of self-regulatory organizations (SROs), such as the National Futures Association and FINRA, and make recommendations for operational, structural, and governance improvements of the SRO framework.

Conclusion

Perhaps because of the logjam in Congress, the Report takes a pragmatic view and focuses largely on actions that can be undertaken by the agencies and SROs acting on their own. As noted above, many of the measures noted as recommendations are already the subject of agency-proposed rules and we may see action, particularly from the SEC, on certain of the equity capital markets and capital formation related matters. There are two additional installments expected from Treasury, one on asset management and insurance, and another on FinTech and other nonbank financial services companies. We look forward to the recommendations and discussions on these areas.

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