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WHITE PAPER

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Department of the Treasury Issues Report Recommending U.S. Capital Markets Regulatory Reforms

The U.S. Department of the Treasury has issued a report to the President recommending extensive regulatory and legislative reforms to the U.S. capital markets. The recommendations, in response to the White House's executive order on core principles for financial regulation, primarily focus on regulatory actions that can be taken by the Securities and Exchange Commission and Commodity Futures Trading Commission. They also address a wide range of issues, including the U.S. regulatory structure, access to capital, and securitization and derivatives requirements. Some of the recommended changes could be implemented soon; however, regulatory actions that require notice and comment could be under consideration into 2019. This Jones Day *White Paper* describes the report's key recommendations.

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The Department of the Treasury ("Treasury") recently issued a report, "A Financial System that Creates Economic Opportunities: Capital Markets," presenting comprehensive regulatory and legislative recommendations for reforming the U.S. capital markets ("Report")[1] in response to the Executive Order "Core Principles for Regulating the United States Financial System" issued earlier this year.[2] Treasury intends the recommendations outlined in the Report to "better align the financial system to serve issuers, investors, and intermediaries to support the Administration's economic objectives and drive economic growth."[3]

The Report recommends improvements to administrative rulemaking and policy processes and the tailoring and harmonizing of a wide range of capital markets regulations. Most of the policy recommendations in the Report address steps Treasury believes the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") should take to promote access to capital and support U.S. capital markets. The Report provides more than 90 policy recommendations, of which nine would involve congressional consideration.

This *White Paper* provides a summary of key recommendations in the Report set forth within each of the following seven categories and concludes with some observations:

1. Regulatory structure and processes focusing in particular on coordination among regulators;
2. International standard-setting to help ensure a level playing field for U.S. interests internationally;
3. Access to capital, especially for small businesses;
4. Fostering secondary markets in equity and debt;
5. Recalibrating securitization requirements to avoid impeding capital formation;
6. Harmonizing derivatives regulation to promote market efficiency and mitigate risk; and
7. Improvements to oversight of systemically important Financial Market Utilities ("FMUs").[4]

REGULATORY RECOMMENDATIONS

Regulatory Structure and Processes

The U.S. capital markets generally consist of the securities markets and derivatives markets, and they are regulated by two federal regulators, the SEC and CFTC; by self-regulatory organizations ("SROs") that are subject to oversight by the SEC and CFTC; and by state securities regulators.[5] The Report notes that the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") amended the Commodity Exchange Act ("CEA") and the Securities Exchange Act ("Exchange Act") to limit CFTC and SEC authority to grant exemptions. It also highlights "a number of areas in which the agencies can improve their processes for making and implementing regulatory policy decisions."[6]

- **Exemptive Authority.** The Report recommends restoring to the SEC and CFTC exemptive authority under the Exchange Act and the CEA, which had been amended by the Dodd-Frank Act to limit the agencies' ability to grant exemptions regarding certain activities subject to Title VII of the Dodd-Frank Act.[7]

- **Improving Regulatory Policy Decision-Making.** Treasury's recommendations address enhanced use of regulatory cost-benefit analysis by the CFTC, SEC, and SROs, as well as consistency of CFTC and SEC rulemakings and guidance with the Core Principles. Treasury also recommends that the CFTC and SROs issue public guidance regarding the factors considered when conducting rulemaking economic analyses.[8] In addition, Treasury recommendations also address CFTC and SEC use of public input and periodic reviews of their rules, the use of principles-based regulation, and rule harmonization.[9] Treasury recommends that the CFTC and SEC avoid imposing new requirements through guidance, outside the notice-and-comment process; affirmatively review existing guidance that has caused confusion and compliance challenges; and review and update various definitions.[10]

- **Self-Regulatory Organizations.** The Report recommends comprehensive CFTC and SEC reviews regarding SROs, in part to identify any changes to laws or rules necessary to enhance SRO oversight, and further recommends SRO reviews of their rules, guidance, and procedures on a periodic basis.[11]

International Aspects of Capital Markets Regulation

The Report states that cross-border access to capital markets enhances capital market efficiencies and stability through better allocation of savings and better risk sharing. Treasury explains that appropriate regulation and supervision helps to mitigate risks to the financial system, and international regulatory cooperation "can advance U.S. interests by promoting financial stability, leveling the playing field for U.S. financial institutions, and reducing market fragmentation."[12]

Treasury's recommendations regarding international regulation address: (i) sustaining and developing partner dialogues to address conflicting or duplicative regulation; (ii) seeking to reach outcomes-based, nondiscriminatory substituted compliance arrangements; (iii) advocating for and shaping international regulatory standards aligned with U.S. financial regulatory objectives; (iv) coordinating policy before and after international engagements; and (v) working in international organizations to elevate the quality of stakeholder consultation globally.[13]

Access to Capital

According to the Report, access to capital enables investment in economic growth and the development of new products and services, and it is, therefore, essential to a successful economy, making imperative a "well-designed" regulatory structure for the capital markets.[14] The Report includes recommendations that are intended to "improve the attractiveness" of public markets relative to private markets for capital-seeking businesses, as well as "to expand access to capital more broadly."[15] These recommendations cover public companies and initial public offerings ("IPOs"), challenges for smaller public companies, innovative tools to expand access to capital, and efforts to maintain the efficacy of private capital markets.

The recommendations apply to:

- **Public Companies and IPOs.** Treasury's recommendations address: (i) removing certain disclosure requirements; (ii) permitting additional communications with potential investors prior to an IPO; (iii) studying and evaluating proxy advisory firms; (iv) revising shareholder proposal requirements; (v) investigating means to reduce costs of securities litigation for issuers; (vi) commenting on whether offering documents adequately disclose dual class stock; and (vii) revising the securities offering reform rules regarding business development companies.[16]

- **Smaller Public Companies.** Treasury supports modifying rules that would broaden eligibility for status as a smaller reporting company and as a nonaccelerated filer. Additionally, Treasury's recommendations address extending the length of time a company may be considered an emerging growth company, SEC review of interval fund rules, and SEC review of the 2003 and 2004 global settlement between securities regulators and certain broker-dealer firms and the research analyst rules "with the objective of harmonizing a single set of rules for financial institutions."[17]

- **Innovative Tools.** The Report recommends: (i) increasing flexibility for Regulation A Tier 2 offerings; (ii) allowing single-purpose crowdfunding vehicles advised by a registered investment adviser; (iii) waiving certain crowdfunding offering limits; (iv) amending certain crowdfunding investment limits; (v) modifying the Exchange Act's Section 12(g) exemption; and (vi) increasing the limit on how much can be raised through crowdfunding.[18]

- **Private Markets.** The Report recommends: (i) proposing a new regulatory structure for finders and other intermediaries in capital-forming transactions; (ii) amending the accredited investor definition; (iii) reviewing statutory provisions that restrict unaccredited investors from investing in a private fund containing Rule 506 offerings; and (iv) centralizing reporting of individuals and firms that have been subject to adjudicated disciplinary proceedings or criminal convictions.[19]

Fostering Secondary Markets in Equity and Debt

Equity. The Report indicates that while "the secondary equity market is operating very well" for "the largest companies and most liquid stocks," it is operating less well for less-liquid companies, which are often smaller and newer businesses.[20] Accordingly, the Report presents recommendations that are intended to "improv[e] the market for less liquid stocks, … promote greater transparency, reduce unnecessary complexity, and improve the overall vibrancy of equity markets."[21]

Treasury's equity market structure recommendations in the Report address: (i) reducing liquidity fragmentation in less-liquid stocks; (ii) allowing issuers to determine the tick size for trading of their stock; and (iii) requirements regarding maker-taker markets and payment for order flow.[22] The recommendations also address market data rules, including the need for new guidance regarding best execution obligations; considerations regarding SRO data fees rules; and amendments to Regulation NMS.[23] In addition, the Report addresses amendments to the SEC's Order Protection Rule, SEC review regarding order type harmonization, and amendments to Regulation ATS.[24]

Treasury Market. Treasury highlights recent changes that have affected the Treasury securities market, including the growth in electronic trading, market shifts with regard to Treasury end investors and the roles played by dealers, and the entrance of new types of intermediaries.[25] The Report identifies Treasury securities market data gaps and issues regarding clearing and reporting.[26]

Accordingly, the Report recommends closing the principal trading firms data granularity gap and that the CFTC share its Treasury futures security transaction data. The Report supports the Federal Reserve Board's efforts to collect Treasury transaction data from its bank members.[27] Treasury also recommends further study to better understand clearing and settlement arrangements in the Treasury interdealer broker market, and reiterates its recommendation from the June 2017 depository institutions report that is intended to improve the availability of secured repurchase agreement financing.[28]

Corporate Bond Liquidity. In light of perceived liquidity issues in the corporate bond market,[29] Treasury reiterates its recommendations from the June 2017 depository institutions report that are intended to improve secondary market liquidity.[30] These recommendations include consideration of adjustments to the supplementary leverage ratio and enhanced supplementary leverage ratio, as well as significant changes to the Volcker Rule.[31]

Recalibrating Securitization Requirements

The Report recognizes that securitizing cash flows is a "vital financial tool" that can enable better risk management, access to credit, and reduced funding costs.[32] The Report makes a series of recommendations designed to diminish the effects on securitizations emanating from key post-crisis measures that "… have gone too far toward penalizing securitization relative to alternative" funding sources, referencing the effects of bank regulatory capital, liquidity, risk retention, and expanded disclosure requirements.[33]

- **Capital.** Treasury's capital recommendations address: (i) rationalizing the capital required for securitized products; (ii) adjusting the parameters of the simplified supervisory formula approach and the supervisory formula approach; (iii) sufficiently accounting for the magnitude of the credit risk sold or transferred in determining required capital; (iv) considering the impact that trading book capital standards would have on secondary market activity; and (v) considering adjustments to the global market shock scenario for stress testing.[34]

- **Liquidity.** The Report recommends that high-quality securitized obligations with a proven track record receive consideration as level 2B high-quality liquid assets for purposes of the liquidity coverage ratio and the net stable funding ratio.[35]

- **Risk Retention.** Treasury's risk retention recommendations address: (i) expanding qualifying underwriting exemptions; (ii) exempting collateralized loan obligation managers who select loans that meet certain standards; (iii) reviewing the mandatory five-year holding period for third-party purchasers and sponsors, and potentially reducing the requirement; and (iv) designating one lead agency to be responsible for future actions related to the risk retention rule.[36]

- **Disclosures.** Treasury's disclosure recommendations address: (i) reducing the number of required reporting fields for registered securitizations; (ii) refining SEC definitions to better standardize reporting requirements; (iii) exploring a "provide or explain regime" for certain data fields; (iv) reviewing and potentially reducing the three-day waiting period for registered deals; and (v) signaling that Regulation AB II asset-level disclosure requirements will not be extended.[37]

Harmonizing Derivatives Regulation

Treasury explains that derivatives may be used for the purposes of managing risks and may also be used for speculative purposes.[38] Title VII of the Dodd-Frank Act included regulatory reforms that generally require clearing, exchange trading, data reporting, and capital requirements for certain derivatives,[39] and the Report addresses issues related to the implementation of these reforms.[40]

- **Regulatory Coordination and Harmonization.** Treasury's recommendations address CFTC and SEC reviews of the agencies' Dodd-Frank Act Title VII rulemakings, with the intent of harmonizing rules and eliminating redundancies.[41]

Treasury's margin recommendations address: (i) harmonizing U.S. margin requirements for uncleared swaps and international cooperation, including an affiliate exemption from the initial margin requirement; (ii) tailoring the uncleared margin framework; (iii) amending time frames for collecting and posting margin; (iv) tailoring margin requirements for financial end users; and (v) finalizing the security-based swaps proposed margin rule.[42] Treasury also recommends simplifying and formalizing all outstanding CFTC staff guidance and no-action relief regarding the Dodd-Frank Act swaps regulatory framework.[43]

- **Cross-Border.** Treasury's recommendations address: (i) clarifications to the cross-border scope of CFTC and SEC regulations; (ii) cooperation regarding meaningful substituted compliance programs; and (iii) reconsideration of any U.S. personnel test for applying the transaction-level requirements of CFTC and SEC swaps rules.[44]

- **Capital Treatment in Support of Central Clearing.** Treasury's recommendations address balancing the goal of moving more derivatives into central clearing with tailored capital requirements, including an offset for initial margin and assessing whether capital and liquidity rules are properly calibrated.[45]

- **End-User Issues.** The Report recommends that the CFTC maintain the current swap dealer de minimis registration threshold, and it would support a legislative amendment to Section 2(h)(7) of the CEA, which addresses exceptions to the clearing requirement, to establish CFTC rulemaking authority to modify and clarify the scope of the "financial entity" definition and the treatment of affiliates.[46] Treasury's recommendations also address the CFTC completing the position limits rules, the availability of an end user exemption, and certain considerations regarding the calibration and setting of position limits.[47]

- **Market Infrastructure.** The Report recommends revisions to Swaps Execution Facilities execution methods and the "made available to trade" process, including consideration of rule changes regarding means of swaps execution, reevaluation of the "made available to trade" determination process, and considerations regarding market fragmentation.[48] Treasury supports the CFTC's review of swaps reporting regulations announced in July 2017.[49]

Improvements to Oversight of Systemically Important Financial Market Utilities

The Report discusses nine FMUs in the Report and explains that FMUs "support and facilitate the transfer, clearing, or settlement of financial transactions."[50] The Report identifies issues related to regulatory approval of changes to FMU rules, procedures, and operations; FMU access to accounts at Federal Reserve Banks and safeguarding client margin; and FMU resilience, recovery, and resolution.[51]

Treasury's recommendations address: (i) bolstering resources for the supervision and regulation of systemically important FMUs; (ii) studying how U.S. regulators can streamline the existing advance notice review process; (iii) reviewing financial stability risks arising from the lack of account access and rate of interest on deposits; (iv) incorporating additional potential risks in future central counterparty stress testing; (v) continuing participation in cross-border crisis management groups; and (vi) continuing to advance U.S. interests with international standard setting bodies, such as the Committee on Payments and Market Infrastructures and the Board of the International Organization of Securities Commissions and Financial Stability Board working groups.[52]

CONCLUSION

Most of the recommendations identified in the Report can be achieved without new legislation through actions by the primary regulators of U.S. capital markets: the SEC, CFTC, SROs, and state securities regulators.[53] Although many regulatory recommendations can be accomplished in the near term, rules that must proceed through public notice-and-comment rulemaking will require substantial time before becoming final and could be under consideration into 2019. Some recommendations, such as those for closer coordination among regulators and for review of cross-border swaps guidelines, can begin to be carried out immediately, while other recommendations, such as repeal of the conflict minerals, mine safety, resource extraction and pay ratio mandates in the Dodd-Frank Act, would require congressional consideration.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

Lisa M. Ledbetter
Washington
+1.202.879.3933
lledbetter@jonesday.com

Chip MacDonald
Atlanta
+1.404.581.8622
cmacdonald@jonesday.com

Brett P. Barragate
New York
+1.212.326.3446
bpbarragate@jonesday.com

Stephen J. Obie
New York / Washington
+1.212.326.3773 / +1.202.879.5442
sobie@jonesday.com

Christopher M. Kelly
New York / Cleveland
+1.212.326.3438 / +1.216.586.1238
ckelly@jonesday.com

Colin C. Richard
Washington
+1.202.879.5567
crichard@jonesday.com

ENDNOTES

1 "A Financial System that Creates Economic Opportunities: Capital Markets," U.S. Department of the Treasury (October 6, 2017) (hereinafter, "Report"). This Report is the second in a series of reports to be issued in response to the Core Principles Executive Order. Treasury issued the first report on depository institutions and credit unions on June 12, 2017, and the third report on asset management and insurance on October 26, 2017. Treasury has indicated it will issue a fourth report on financial technology and innovation.

2 The President issued Executive Order 13772, Core Principles for Regulating the United States Financial System ("Core Principles") on February 3, 2017. The Core Principles directed the Secretary of the Treasury ("Secretary") to consult with the federal financial regulators on the extent to which existing laws, treaties, regulations, guidance, and other government policies promote the Core Principles. The Report was required to identify any laws, regulations, guidance, and other government policies that are inconsistent with the Core Principles. "Core Principles for Regulating the United States Financial System," Executive Order 13772, 82 Fed. Reg. 9965 (Feb. 8, 2017).

The Core Principles are: "(a) empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth; (b) prevent taxpayer-funded bailouts; (c) foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry; (d) enable American companies to be competitive with foreign firms in domestic and foreign markets; (e) advance American interests in international financial regulatory negotiations and meetings; (f) make regulation efficient, effective, and appropriately tailored; and (g) restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework." *Id.* at Section 9965.

3 Report at 5.

4 *Id.* at 6.

5 *See id.* at 171.

6 *See id.* at 179-180.

7 *See id.* at 179-180, 218.

8 *See id.* at 180-182, 218-219.

9 *See id.*

10 *See id.*

11 *See id.* at 184-186, 219.

12 *See id.* at 189.

13 *See id.* at 190-192, 220. SEC staff subsequently issued three no-action letters regarding the Markets in Financial Instruments Directive II's ("MiFID II") financial research services requirements. *See* "SEC Announces Measures to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions," SEC Press Release (Oct. 26, 2017). Additionally, the CFTC announced determinations on "comparability and equivalence of margin requirements for uncleared swaps, as well as a common approach regarding certain CFTC and European Union (EU) authorized derivatives trading venues." *See* "CFTC Comparability Determination on EU Margin Requirements and a Common Approach on Trading Venues," CFTC Press Release (Oct. 13, 2017).

14 Report at 21.

15 *Id.* at 25.

16 *See id.* at 29-35, 205. The Report recommends that "the SEC proceed with a proposal to amend Regulation S-K in a manner consistent with" SEC staff's recent recommendations. *See id.* at 30. The SEC has subsequently issued a proposed rule to amend Regulation S-K. *See* 82 Fed. Reg. 50988 (Nov. 2, 2017).

17 *See* Report at 36-38, 206.

18 *See id.* at 39-42, 206.

19 *See id.* at 42-45, 207.

20 *Id.* at 49.

21 *Id.*

22 *See id.*at 59-63, 207.

23 *See id.* at 59-60, 208.

24 *See id.* at 60-67, 208.

25 *See id.* at 71.

26 *Id.* at 79-82.

27 *See id.* at 79-80, 209.

28 *See id.* at 81-82, 209.

29 See *id.* at 86-87.

30 *See id.* at 87-88, 209.

31 "A Financial System that Creates Economic Opportunities: Banks and Credit Unions," U.S. Department of the Treasury, 14-15 (June 12, 2017). *See also* Jones Day's *White Paper* regarding the June 2017 depository institutions report.

32 *See* Report at 91.

33 *See id.* at 95-96.

34 *See id.* at 97-100, 210.

35 *See id.* at 100-101, 210.

36 *See id.* at 101-103, 211.

37 *See id.* at 103-105, 211.

38 *See id.* at 109.

39 *See id.* at 116-120.

40 *See id.* at 126.

41 *See id.* at 126-127, 212.

42 *See id.* at 127-130, 212.

43 *See id.* at 130-132, 213.

44 *See id.* at 132-136, 213-214.

45 *See id.* at 136-138, 215.

46 *See id.* at 139-142, 215.

47 *See id.* at 142-143, 216.

48 *See id.* at 143-145, 216.

49 *See id.* at 146-147, 216.

50 *See id.* at 151.

51 *See id.* at 164-167.

52 *See id.* at 164-167, 217.

53 The Report makes more than 90 recommendations, nine of which would require legislation to accomplish.