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Treasury Department Issues Report on Capital Markets, the Second Report in a Series on Financial Regulatory Reform

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October 11, 2017 TO: ICI Members
ICI Global Members
Derivatives Markets Advisory Committee
Equity Markets Advisory Committee
Fixed-Income Advisory Committee
ICI Global Trading & Markets Committee
SEC Rules Committee SUBJECTS: Derivatives
Fixed Income Securities
Trading and Markets RE: Treasury Department Issues Report on Capital Markets, the Second Report in a Series on Financial Regulatory Reform

The Treasury Department recently issued a report entitled *A Financial System that Creates Economic Opportunities: Capital Markets* (Capital Markets Report).[1] This is the second of four reports in response to Executive Order 13772, which identifies several high-level principles intended to guide financial regulation by the Trump Administration.[2] ICI as well as a number of members provided input to Treasury during the engagement process for the report.

The Capital Markets Report provides an overview of the US capital markets and makes 91 recommendations to better align the financial system to serve issuers, investors, and intermediaries to drive economic growth.[3] Most recommend regulatory, rather than legislative, action to address Treasury's concerns. The recommendations focus on the following nine areas: (1) access to capital; (2) equity market structure; (3) US Treasury market structure; (4) corporate bond liquidity; (5) securitization; (6) derivatives; (7) financial market utilities; (8) regulatory structure and process; and (9) international aspects of capital markets regulation.[4] This memorandum summarizes the recommendations that may be of most interest to regulated funds.

Access to Capital

The Capital Markets Report expresses concern about the declining number of public companies in the United States because public companies provide a useful investment vehicle for millions of retail investors. The report notes that if many successful new companies stay private, middle-class Americans may miss out on the significant returns they generate for investors.[5] At the same time, however, the Capital Markets Report recognizes the importance of private markets as flexible alternatives for obtaining financing for entrepreneurial efforts. To that end, the report recommends the following:

- Eliminate duplicative, overlapping, outdated, or unnecessary disclosure requirements on public companies and liberalize pre-initial public offering communications;
- Expand the “accredited investor” definition;
- Facilitate pooled investment in private or less liquid offerings;
- Heighten requirements for submitting shareholder proposals;
- Review interval fund rules to encourage creation of closed-end funds that invest in offerings of smaller public companies and private companies whose shares have limited or no liquidity; and
- Study and evaluate proxy advisory firms and consider regulatory responses to promote free market principles.

Equity Markets

The Capital Markets Report expresses concern about potential conflicts of interest in the US equity markets and expresses concern that market quality is uneven—market quality is generally better for larger companies than smaller ones. The report makes a number of recommendations, including several that would address ICI priorities. These include the following:

- Adopt an SEC rule proposal that would require broker-dealers to disclose their order handling practices for institutional orders;
- Implement an SEC pilot program on maker-taker pricing;
- Adopt new disclosure requirements for alternative trading systems (ATSs) that would enable institutional investors and other market participants to assess the conflicts of interest associated with using ATSs;
- Consolidate liquidity for less-liquid stocks on a smaller number of trading venues by allowing issuers to suspend (partially or fully) unlisted trading privileges;
- Consider allowing issuers to determine appropriate tick size for their stocks;
- Clarify that broker-dealers can satisfy their best execution requirements by relying on securities information processors (SIPs), and allow competing consolidators as an alternative to the SIPs;
- Amend the order protection rule in SEC Regulation NMS to give protected quote status only to national securities exchanges that meet a minimum liquidity threshold; and
- Review and consider harmonizing order types to reduce market complexity.

US Treasury Market Structure

The Capital Markets Report assesses changes in the liquidity and structure of the secondary market for US Treasury securities since the financial crisis. The report explains regulatory efforts to improve the monitoring and oversight of these markets but expresses concern that regulators do not have adequate visibility into the activities of principal trading firms (PTFs). The report’s recommendations on Treasury market structure are designed to improve regulatory understanding and increase efficiency of this market. In particular, the recommendations include the following:

- Obtain more comprehensive information about the activities of PTFs by requiring trading platforms operated by FINRA member broker-dealers to identify customers in their reports to TRACE;[6]
- Study clearing and settlement arrangements in the Treasury interdealer broker

market; and
- Share data on the Treasury futures market, presently collected by the Commodity Futures Trading Commission (CFTC), with Treasury.

Corporate Bond Liquidity

The Capital Markets Report expresses concern about changes in corporate bond liquidity and market structure since the financial crisis and reiterates its prior recommendations on improving secondary bond market liquidity.[7] These recommendations include:

- Consider adjustments to the supplementary leverage ratio and the enhanced supplementary leverage ratio to address unfavorable impacts that requirements may have on market liquidity and low-risk assets; and
- Change the Volcker Rule significantly to eliminate undue burdens and unnecessary impact on market liquidity.

Securitization

The Capital Markets Report describes changes to the securitization market since the financial crisis and expresses concern that post-crisis reforms have gone too far toward penalizing securitization relative to alternative funding sources. The report states that these reforms have reduced the attractiveness of securitization, potentially cutting off or raising the costs of credit to thousands of corporate and retail customers. The report contains several recommendations to address these concerns, including:

- Rationalize capital requirements for securitized products with the capital required to hold the same disaggregated underlying assets;
- Expand qualifying risk retention exemptions across eligible asset classes based on unique characteristics of each securitized asset class through rulemaking;
- Review the mandatory five-year holding period for third-party purchasers (which may include regulated funds) and sponsors;
- Review and recalibrate the disclosure requirements applicable to securitizations by reducing the number of reporting fields required by SEC Regulation AB II, and providing issuers more flexibility in satisfying their disclosure requirements; and
- Review and recalibrate the disclosure requirements applicable to securitizations under SEC Regulation AB II (information on underlying assets), as well as the current mandatory 3-day waiting period for a registered offering.

Derivatives

The Capital Markets Report describes the regulatory landscape for the derivatives markets and notes that there is widespread support for the reforms adopted in the wake of the financial crisis. The report identifies a number of areas where the implementation of these reforms could be improved. These include the following:

- Harmonize CFTC and SEC regulations for swaps and security-based swaps;
- Address discrepancies in the margin treatment for swaps and security-based swaps:
    - Harmonize margin requirements for uncleared swaps domestically and internationally (including timing of margin settlement); and
    - Repropose margin requirements for uncleared security-based swaps and adopt final rules that are aligned with the margin rules for swaps;
- Simplify and formalize all outstanding CFTC staff guidance and no-action relief;
- Clarify the cross-border application of CFTC and SEC derivatives rules and make these rules compatible with non-US jurisdictions where possible;
- Liberalize swap execution facility trading protocols and reevaluate the process to

determine whether a swap should be required to be traded on a swap execution facility or designated contract market; and
- Standardize swap data reporting requirements and improve the quality of data reported to swap data repositories.

Financial Market Utilities

Financial market utilities (FMUs) exist to support and facilitate the transfer, clearing, or settlement of financial transactions. The Capital Markets Report notes that the smooth operation of financial market utilities is integral to the soundness of the financial system and the overall economy. The report expresses concern that the regulatory oversight and resolution regimes for FMUs that are of systemic importance remain insufficient. The report recommends steps to enhance the oversight of financial market utilities, including:

- Develop more robust clearing house supervisory stress tests; and
- Coordinate, domestically and internationally, on the development of viable recovery wind-down plans for CCPs that are systemically important and focus additional recovery and resolution planning efforts on nondefault scenarios.

Regulatory Structure and Process

The Capital Markets Report identifies areas of regulatory fragmentation, overlap, and duplication and recommends steps to modernize and rationalize this complicated framework. The report also describes arguments for and against merging the CFTC and SEC and determines that merging these two agencies would not appreciably improve the current regulatory system. Instead the report suggests a number of recommendations, including:

- Grant the CFTC and SEC full exemptive authority by removing Dodd-Frank's limitation on the ability of these agencies to issue exemptions from the Commodity Exchange Act and Securities Exchange Act of 1934, respectively;
- Ensure that rulemakings of self-regulatory agencies consider economic analysis;
- Make fuller use of the ability to solicit comment and input from public;
- Conduct regular, periodic review of CFTC and SEC rules for burden, relevance, and other factors;
- Avoid imposing new requirements by informal processes, such as no-action letters, interpretation, or guidance; and
- Conduct a comprehensive review of the roles, responsibilities, and capabilities of SROs and make recommendations for improvement of SRO framework.

International Aspects of Capital Markets Regulation

The Capital Markets Report notes that cross-border financial integration enhances efficiency—through better allocation of savings—and stability—through better risk sharing. The report notes that capital markets are increasingly global in nature and are becoming highly integrated and interdependent. In this context, the report recommends steps that US agencies can take to engage with international regulators and international financial regulatory standard setting bodies to advance American interests. These recommendations include the following:

- Develop and sustain technical level dialogues with key partners and focus on finding outcomes-based, non-discriminatory substituted compliance arrangements to address conflicting or duplicative regulations;
- Advocate for international regulatory standards that are aligned with domestic financial regulatory objectives; and

- Work in international organizations to elevate the quality of stakeholder consultation (*e.g.* by seeking robust comment procedures, consistent with those provided by the Administrative Procedure Act).

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endnotes

[1] The report is *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

[2] The executive order is *available at* https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-executive-order-core-principles-regulating-united-states.

[3] These recommendations are set out in Appendix B of the report.

[4] For more information about the context in which the report is issued, *see* ICI Memorandum 30748 (June 20, 2017), *available at* https://www.ici.org/my_ici/memorandum/memo30748.

[5] The report notes a number of factors that potentially contribute to the reluctance of companies to go public, including increased disclosure and other regulatory burdens, shareholder litigation risk, lack of research coverage for smaller companies, and the growth of mutual fund size (which makes holding smaller positions less attractive).

[6] Although this recommendation focuses on identifying PTFs, the identities of other customers—such as regulated funds—also could be disclosed to TRACE.

[7] *See A Financial System That Creates Economic Opportunities: Banks and Credit Unions (June 2017)* ("Banking Report"), at 14-15, *available at* https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf.
