
By Mark S. Nelson, J.D.

Treasury Secretary Steven Mnuchin published the report on financial regulation core principles that had been requested in an executive order issued by President Trump. Much of report deals with banking issues, but several items broadly apply to swaps and derivatives regulations, the rulemaking process at independent financial agencies, and the Volcker rule. Some of the recommendations in the report have been captured in various bills in Congress, although the report, at times, suggests a few more nuanced approaches than lawmakers have so far advocated.

Reaction by Democratic lawmakers has been swift. House Financial Services Committee Ranking Member Maxine Waters (D-Cal) linked the Treasury report and the Financial CHOICE Act of 2017. "In many areas, this plan is as brazen and openly regressive as the Wrong Choice Act. It too would destroy the Consumer Bureau, and roll back critical rules in place to ensure the stability of our financial system," Waters said in a statement. Senator Elizabeth Warren (D-Mass) said Democrats would not give into the "Trump-Mnuchin financial deregulation plan."

Meanwhile, Senate Banking Committee Ranking Member Sherrod Brown offered to work with Republicans on more focused legislation that would not upset the balance achieved in the Dodd-Frank Act. "Too many hardworking Americans still haven’t fully recovered from the financial crisis, and Washington should be focused on protecting them by holding Wall Street accountable, not doing its bidding," Brown said in a statement. Brown also chided Treasury for allegedly consulting with far more industry groups than consumer groups in preparing the report.

Kenneth Bentsen, Jr., president and CEO of the Securities Industry and Financial Markets Association observed that "[r]edundant and conflicting rules, or measures that unnecessarily outweigh stability over investment can result in inefficient regulation and stifle our growth potential." According to Bentsen, financial confidence is grounded in "[c]lear market rules and prudent capital standards." Bentsen "commended" Treasury for the completeness of its review.

Capital, liquidity, margin. Overall, the report said banks are better capitalized in the years since the onset of the Great Recession. The purpose of bank capital and liquidity rules, said the report, is for these requirements to interact to produce a guard against losses and insolvency during times of stress. But too stringent capital requirements may limit economic growth.

Treasury recommended several issues that regulators can address going forward, including: (1) tailoring rules based on an institution’s size and complexity; (2) reducing regulatory burdens and increasing transparency; and (3) improving "regulatory coherence" to enable banks to promote liquid markets.

With respect to regulatory coherence, the report noted how overreliance on the leverage ratio can encourage risky behaviors. Specifically, the report said central clearing firms may be less willing to provide these services in a high leverage ratio environment because of the clearing business’s low-margin, high-volume structure.

The report cited a speech by CFTC Acting Chairman J. Christopher Giancarlo as an example of how comparatively small changes in how the leverage ratio treats initial margin can result in improved market activity. Speaking to a global audience in Lisbon, Portugal, Giancarlo said CFTC estimates indicated that a 70 percent drop in clearing capital costs could result from a one percent drop in the supplemental leverage ratio.
"Assuming these savings are fully passed on to their customers, these reductions could translate into a threefold increase in trading activity, especially hedge positions that are carried overnight," said Giancarlo. "This dramatic reduction in costs on a service imperative to managing systemic risk in swaps is entirely worth the tradeoff of a miniscule reduction in balance sheet protection. The financial system will be safer and more stable for it."

The Treasury report also cited Giancarlo regarding changes in the clearing industry since 2002. According to Giancarlo, Banks’ affiliated futures commission merchants have been impacted by these changes, which have seen the FCM industry shrink from 100 to 55 firms during the last 15 years.

**Independent agencies’ cost-benefit analysis.** Treasury would have the independent agencies, such as the SEC and the CFTC, engage in more cost-benefit analysis when they issue regulations. The report noted the lack of uniformity and "analytical rigor" in cost-benefit analyses performed by some independent agencies. As a result, the report cited the GAO’s recommendation that independent financial agencies more closely adhere to OMB guidance under Executive Order 12866, which states cost-benefit analysis requirements for executive agencies, but currently exempts independent agencies.

The report also noted that law makers had introduced legislation with similar goals. The report cited as an example the Independent Agency Regulatory Analysis Act of 2015 (H.R. 1607), introduced in the last Congress by Rob Portman (R-Ohio). Similar bills in 115th Congress would impose stringent requirements on rulemaking at many independent financial regulatory agencies:

- Financial CHOICE Act (H.R. 10)—Among other things, the bill would limit rulemaking where the quantified benefits do not outweigh quantitative costs. (Passed House 233-186).
- Regulatory Accountability Act of 2017 (H.R. 5)—The bill lists agency considerations for rulemaking and major guidance. (Passed House 238-183).
- Commodity End-User Relief Act (H.R. 238)—Section 202 requires the CFTC to consider the costs and benefits of its rules in addition to making other agency reforms. (Passed House 239-182).
- SEC Regulatory Accountability Act (H.R. 78)—States cost-benefit considerations for the SEC. The bill also would require the Commission to determine whether rules of the MSRB or any national securities association complied with the bill. A sense of Congress appended to the bill urges application of the bill requirements to the PCAOB. (Passed House 243-184).

These bills have numerous companions and, in some instances, direct analogs that have been introduced in the Senate.

**Volcker rule.** Treasury’s recommendations regarding the Volcker rule are extensive. Generally, the report concluded that the existing Volcker rule is too broad regarding the scope of firms it captures, requires input from too many regulators, contains "ambiguous" definitions, and requires compliance regimes that are too complex. "In its design and implementation, however, the Volcker Rule has far overshot the mark," said the report. As a result, Treasury recommended:

- Creating an exemption for smaller firms—These firms’ small size and scant proprietary trading pose little risk and, to the extent these firms engage in proprietary trading, they would be expected to remain subject to safety and soundness regulations.
- Exempt banking organizations with no more than $10 billion total consolidated assets—The report said existing "accommodations" for these firms do not go far enough.
- Add an exemption for firms with more than $10 billion in assets—The exemption would apply to all consolidated banking organizations with less than $1 billion in trading assets/ liabilities representing no more than 10 percent of total assets (the exemption would be analogous to the current market risk capital rules). The proposed change also could allow the purpose test, which the report later said was too subjective, to be dropped from the definition of proprietary trading. Banking entities with more than $10 billion in assets would still have to comply with the covered funds requirements.

Moreover, the report offered additional recommendations that it said could refine application of the Volcker rule. These include: (1) calling on regulators to add flexibility to market making rules; (2) easing the documentation
burdens regarding hedging; (3) allowing firms to use more tailored compliance regimes; and (4) streamlining the covered funds rules, which the report said are too complex, in part, because of their references to the Investment Company Act.

The retention of much of the Volcker rule, albeit with significant adjustments, stands in contrast to the complete repeal of the Volcker rule required by the Financial CHOICE Act. Treasury’s report only sparingly mentioned the CHOICE Act. But the report did suggest the possibility of creating a Volcker rule opt-out for well-capitalized banks.

Companies: Securities Industry and Financial Markets Association