WASHINGTON

Newsletter

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Kicking off a divided Congress

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Letter to the reader

We're excited to debut a new look for our first Washington Newsletter of 2023. In addition to our primary focus on Washington DC, going forward, we'll be including global views from our colleagues in London, Brussels, and Hong Kong. Another key modification is to our articles, which are shorter and more accessible for a quick read. In between newsletters, we will continue to produce single-issue topic pieces, which will provide you with the same in-depth analysis and insights you've come to expect from our team. We hope you find these changes helpful as we continue to bring you the latest updates across politics and policy.

Thank you, and please don't hesitate to reach out with any feedback.

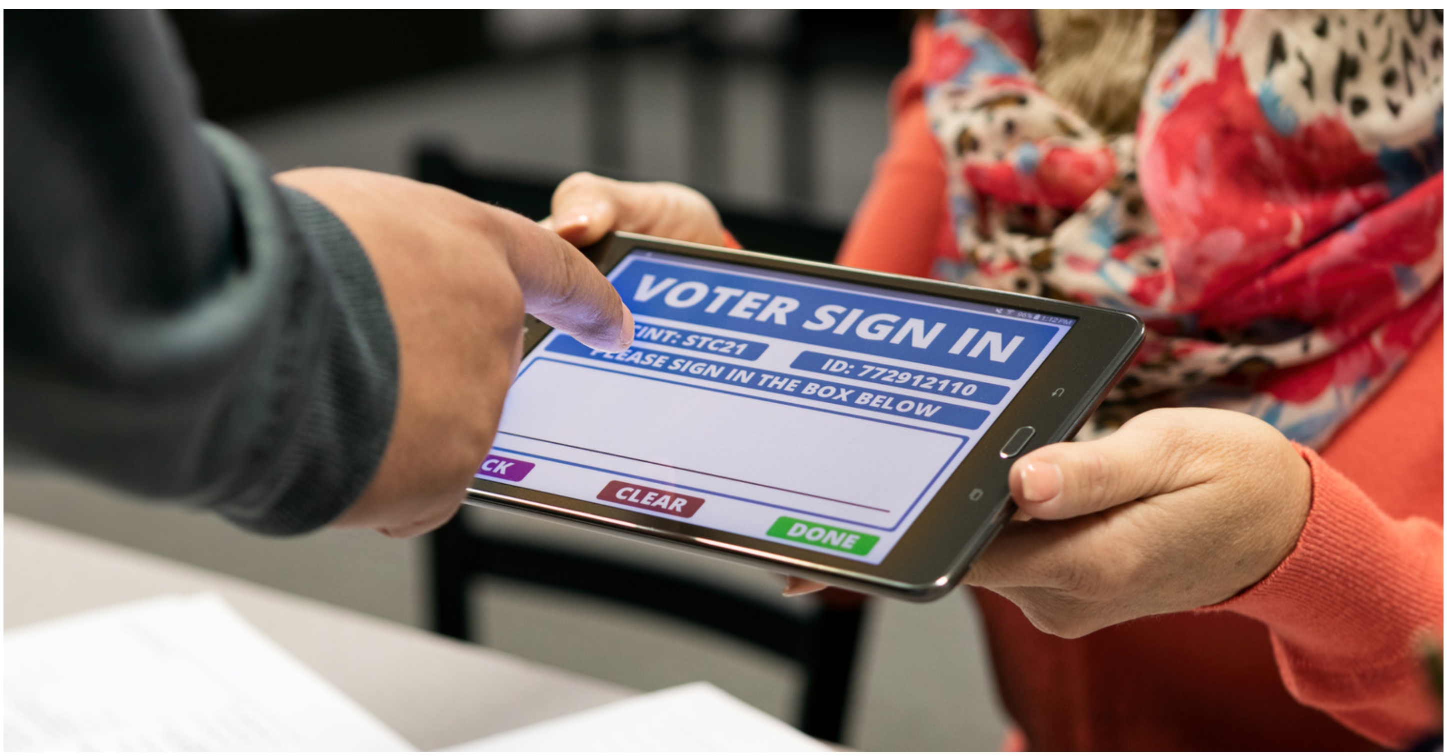
Best,
Andy Blocker

US politics and elections

After a slight delay and some added drama, the 118th Congress has officially begun, and divided government has returned to Washington. Billions of dollars were spent on the 2022 midterm election, and the net result was a single Senate seat changing hands from Republican to Democrat and the House of Representatives flipping control to Republicans by a five-seat margin. This led to the election of Speaker Kevin McCarthy (R-California).

With voters delivering a mixed verdict, policymakers are in many ways still trying to figure out what it means for their respective agendas. First and foremost, President Joe Biden delivered a State of the Union address on Feb. 7 where he laid out his administration's accomplishments thus far and his priorities for this new political era. Although delayed in the House, both chambers have now organized, elected their leadership, populated committees, and have begun introducing priority legislation. Biden started the year with a photo-op at the southern border and a new potential political challenge when it comes to his storage of sensitive and confidential documents from his time as vice president. With this backdrop, a key existential question is whether Biden will continue his effort to be a "transformational" president and push policies that appease progressives but have little possibility of becoming law or surviving legal challenge. Observers will look for early directional signals and hints, yet there is always the list of "must pass" legislation that will prove the true test of the president's ability to navigate divided government.

At the top of any list of "must pass legislation" is a deal to increase the debt limit before the US Treasury's identified date of default. For more than a decade, Republicans have shown a willingness and a comfort with using the potential of default as a source of leverage against Democrats on federal spending. A 2011 agreement between former President Barack Obama and then Speaker John Boehner (R-Ohio) provides a roadmap of what can happen in any spending deal, but Democrats today are reluctant to continue to reward Republican intransigence on the basic responsibility of paying debts already incurred. So, 2023 has begun with a robust exercise in red-line drawing by both parties. It seems likely that there will be no larger standoff in 2023 than the fight over the debt ceiling.



Washington policy and regulation

Legislative & regulatory outlook

The House passed a rules package that could significantly impact its ability to legislate over the next two years. This is particularly true on budget matters, including government funding and a debt limit increase (likely necessary in Q3 2023), and sets the stage for impending fiscal fights that create downward pressure on federal spending for the next two years.

House Republicans stand ready to use their new majority to launch several investigations into the Biden administration and business community. Such topics include border security, COVID origins, Afghanistan withdrawal, energy prices, Environmental, Social & Governance (ESG), Big Tech, and pandemic relief funds, among others. Republicans' new Select Committee on China is expected to be investigative, leading to a report with legislative recommendations to strengthen US competitiveness with China. Congress is also starting to consider additional retirement legislation to build on the passage of SECURE 2.0. On taxes, a divided Congress lowers the prospects for significant tax legislation.

With respect to ESG, Republicans plan to press major asset managers and other companies against taking environmental or societal stances on business practices. Also, the Securities and Exchange Commission (SEC) has several ESG proposals pending, such as climate change and cybersecurity risk disclosures, with more expected this year.

Digital assets will remain a top priority on both sides of the aisle. Bipartisan negotiations are still possible this Congress, but intensified interest and sensitivity to the FTX[1] fallout and questions around regulatory jurisdiction may complicate near-term passage of comprehensive cryptocurrency legislation. Most of the action may come from enforcement activity by the SEC and Department of Justice, with others watching for the impending SEC ruling on the Ripple lawsuit, which could impact future regulation and determine if a cryptocurrency is a security or a commodity.

The Office of Information and Regulatory Affairs Fall 2022 Regulatory Agenda offers some insight into federal agencies' 2023 priorities, though not comprehensive of all current regulatory activity within each agency. With less movement of legislation expected under a divided Congress, the Biden administration will likely focus much of its attention on finalizing its regulatory agenda; implementing the infrastructure law, Inflation Reduction Act, and CHIPS[2] legislation; and, prioritizing executive action to accomplish its other policy goals.

1. FTX Trading Ltd. is a bankrupt company that formerly operated a cryptocurrency exchange and hedge fund.

2. Creating Helpful Incentives to Produce Semiconductors and Science Act of 2022

Financial services

If the recent three-ring circus surrounding the election of the Speaker of the House is any indication, the 118th Congress looks to be one of the most bitterly divided in history. This will make it exceedingly difficult to get any meaningful legislation passed in the financial services arena — but that doesn't mean lawmakers won't try.

Under the leadership of Chairman Patrick McHenry (R-North Carolina), look for the House Financial Services Committee to prioritize work on a financial data privacy package, crypto legislation, pro-capital formation initiatives, and oversight targeted at "woke capitalism" and ESG. As a Democrat up for election in 2024 in an increasingly red state, Senate Banking Committee Chair Sherrod Brown (D-Ohio) is expected to take a more moderate stance on the committee but will continue to focus on pet progressive issues such as housing affordability, consumer protection, and climate risk.

With Congress at a stalemate, most of the action will likely be with the financial services regulators. At the SEC, Chair Gary Gensler will be focused on finalizing over two dozen proposed rules, including the controversial climate disclosure and market structure reforms. Also, on the horizon will be banking regulators revisiting capital requirements that were eased under former President Donald Trump, and to scrutinize bank mergers. And not last to the party, Consumer Financial Protection Bureau Director Rohit Chopra has a packed rulemaking agenda with items related to consumer access to financial records, credit card penalties, and overdraft fees.

Geopolitics

Entering the new year, two elements will continue to dominate the United States geopolitical landscape: the status of the country's relationship with China and the ongoing war between Russia and Ukraine.

China

The Biden administration and Congress have focused significant resources — through executive action, export controls, and the CHIPS Act — to help the US retain a competitive edge against China in a variety of industries. This commitment of resources is expected to continue. The State Department recently formed the Office of China Coordination, or China House, another sign of the concerted effort across government to prioritize competition with China. The administration has redoubled efforts to deepen its regional alliances and partnerships by launching the Indo-Pacific Economic Framework, making new investments in US-ASEAN[3] ties, revitalizing the Quadrilateral Security Dialogue, and establishing the US-Pacific Partnership. As the new Republican majority takes control of the House of Representatives, they have established a Select Committee on China to develop a "whole of government approach" to "ensure America is prepared to tackle the economic and security challenges posed by the Chinese Communist Party." The House has already considered a bill to prohibit the Secretary of Energy from sending petroleum products from the Strategic Petroleum Reserve to China.

Russia/Ukraine

Following a visit from Ukrainian President Volodymyr Zelenskyy, the Biden administration announced additional military aid to Ukraine, including $1.85 billion in Patriot missile systems and other advanced technology. Additionally, Congress appropriated $45 billion in emergency security and humanitarian aid to the country as part of its end-of-year omnibus spending bill. As the war has continued into the winter, Russia has stepped up its bombing campaign of critical energy infrastructure in Ukraine, leaving significant portions of the country without power. The prospects of peace talks remain slim, as Russia has refused to negotiate until territory that it unlawfully annexed is recognized by the international community as Russian.

3. Association of Southeast Asian Nations

Global lens

Is this the start of a green trade war?

News that the US was finally joining the green bandwagon upon the passage of the Inflation Reduction Act (IRA) was initially met with joy in Europe. However, that joy quickly turned to anger as European firms realized that they would effectively be excluded from the IRA's lucrative subsidies.

Once it became clear that any direct lobbying of the US to revise the IRA to include European companies would be limited in success, and that Europe risks losing its green industries that it has painstakingly built over the past decades to the US, discussions quickly pivoted to how the European Union (EU) can develop its own green subsidy regime to maintain its comparative advantage. However, this idea faces a number of obstacles. First, is the issue of fiscal headroom, as many EU governments already have high debt-to-GDP (gross domestic product) ratios post-COVID and therefore are limited in their largesse to homegrown companies. Second, is the EU's existing regulatory regime, known as "state aid," which circumscribes the ability of governments to subsidize their national industries. There is also the risk that any measures could be deemed incompatible with World Trade Organization (WTO) rules.

Countries with fiscal headroom, such as Germany, are in favor of relaxing the EU's subsidy regime. Other countries with more limited fiscal capacity, such as Italy and France, are only in favor if this were coupled with an EU-level pot from which to fund such subsidies. And still, others are against any deviation from the EU's liberal and free-trade ethos.

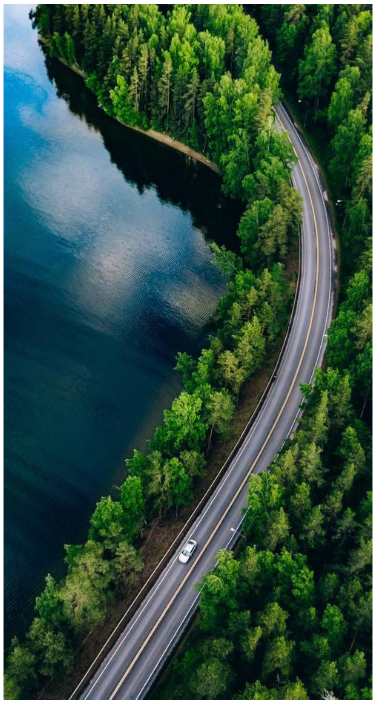
Finally, while the EU may be fuming about the US IRA, it's important to remember that the EU may be on the receiving end of similar criticism given its decision to introduce a Carbon Border Adjustment Mechanism (CBAM), which will penalize exports into the bloc unless the carbon price applied is equivalent to that of the EU. In many ways, the CBAM is the stick to the US IRA's carrot, and both are likely to trigger significant concerns about a new round of trade barriers being erected.

Are UK-EU relations finally thawing?

It appears Spring has come early for UK-EU relations. The antagonism that characterized the relationship under Boris Johnson and (briefly!) Liz Truss has been replaced with a new sense of pragmatism under new Prime Minister Rishi Sunak.

Despite having supported Brexit, Sunak is more trusted by EU leaders than either of his immediate predecessors – reflected in the fact that President Emmanuel Macron will host, in March, the first UK-France bilateral Summit in five years. This greater trust has helped engender confidence that Sunak is genuinely committed to negotiating a solution to the implementation of the Northern Ireland Protocol, the main block on more constructive relations. Progress in negotiations is being downplayed by both sides to suit domestic audiences, but the mood music from both camps is more positive than at any time in recent years. The Brexit purist wing of Sunak's party will be reluctant to accept any agreement that falls short of its red lines. But the prime minister may judge that, with the Opposition's support, the gains from doing a deal – like removing the (albeit low) risk of a trade war with the EU – will be worth the risk.

Spring hasn't sprung yet, but the ice is definitely thawing.



UK to regulate stablecoins, DLT (distributed-ledger technology) market infrastructures and crypto assets

The UK government's Financial Services and Markets Bill was introduced to the UK Parliament in July last year and is expected to become law this Spring. Among its initial aims was the regulation of stablecoins[5] used for payment purposes, as well as entities providing related services, and the establishment of regulatory sandboxes facilitating the testing of financial market infrastructures that utilize distributed ledger technology. However, over the last few months, the UK government has extended the bill's scope to include the regulation of crypto assets.

More specifically, the legislation would empower the UK Financial Conduct Authority (FCA) to authorize, supervise, and enforce against firms that are carrying out certain activities, including investments, advice, and promotions, in relation to a broad suite of crypto assets defined as "any cryptographically secured digital representation of value or contractual rights that (i) can be transferred, stored or traded electronically, and (ii) uses technology supporting the recording or storage of data (which may include distributed ledger technology)."

International standard setters to update fund liquidity risk management principles

In publishing assessments of their respective recommendations on liquidity risk management within open-ended investment funds, the Financial Stability Board (FSB)[6] and the International Organization of Securities Commissions (IOSCO)[7] found that member jurisdictions had made "meaningful progress" over the last few years in implementing internationally agreed rules governing the operation of such funds.

However, while the FSB and IOSCO found that fund liquidity risk management principles published in 2017/2018 remained appropriate, the global bodies and their member jurisdictions have agreed to enhance and further clarify the regulatory outcomes that they are seeking to achieve over the coming year.

This will work to include, for example, developing a more sophisticated framework for assessing the liquidity of different asset classes, including enhanced data reporting and stress testing, and for implementing anti-dilution and liquidity management tools within open-ended investment funds.

China is back

With its wholehearted pivot away from zero-COVID policy, China is now ready to lure foreign investments back. This was echoed at the Central Economic Work Conference in December 2022 and in Vice Premier Liu He's speech at Davos 2023, which all signaled a shift to a more pro-business outlook, commitment to support entrepreneurs and platform economies, and a keen desire to rebuild consumer confidence and demand. New license approvals were granted to foreign players in the last couple of months[4] as the efforts to re-open China sped up. COVID fatalities may present only a short-term drag on domestic consumer confidence and demand in China, and that will likely be overshadowed by renewed market friendly policies behind China's growth engine.

4. Neuberger Berman, Fidelity and Schroders each received approval to operate wholly foreign owned securities fund management company, whilst Manulife and JP Morgan each won approval to acquire 100% of the shares in its securities fund management joint venture company.

5. Stablecoins are cryptocurrencies whose value is pegged to that of another currency.

6. The Financial Stability Board (FSB) is an international body that monitors and makes recommendations about the global financial system.

7. The International Organization of Securities Commissions (IOSCO) is the international body that brings together the world's securities regulators and is recognized as the global standard setter for the securities sector.

Divergent approach to crypto

Elsewhere in Asia, regulators are taking divergent approaches to stablecoins and crypto assets. On one hand, the Monetary Authority of Singapore has proposed new regulatory measures on cryptocurrency trading and stablecoins, whilst the Reserve Bank of Australia is considering how to implement stablecoins into the national payment ecosystem without exposing it to excessive risks. On the other hand, Hong Kong is taking a more inclusive approach and will soon be issuing new anti-money laundering and licensing rules for virtual asset service providers operating in the jurisdiction as a major step toward formalizing a crypto regime. Despite the fallout from FTX collapse, by adopting a policy that is in sharp contrast to China's complete ban on crypto transactions, the Hong Kong regulators still seem eager to demonstrate to the world that the One Country Two Systems principle remains strong and intact.

On the horizon

Note: Federal Reserve Chair Powell will testify before Congress during this time period. Those dates have not been announced.

Key Washington Dates

February-March 2023

02.06: Technical due date for President to deliver his budget proposal to Congress

02.07: State of the Union

02.08: House Financial Services Committee (HFSC) Hearing on China

02.08: HFSC Subcommittee on Capital Markets: Two Hearings on Capital Formation

02.14: Comment period closes on SEC Proposed Rulemaking on Investment Company Liquidity Risk Management

02.27: Comment Period Closes on SEC Regulation Best Execution proposal

03.08: HFSC Semi-Annual Monetary Policy Hearing with Fed Chairman Powell

03.09: President's Budget Projected Release Date

03.09: HFSC Hearing on Digital Assets

03.10: HFSC Subcommittee on Capital Markets: Capital Formation Hearing III

03.15-16: March Federal Open Market Committee Meeting

03.22: HFSC Full Committee Capital Formation Hearing

03.27: Comment period closes on SEC proposed rulemaking on Prohibition Against Conflicts of Interest in Certain Securitizations

03.28-29: HFSC mark-up of Capital Formation Legislation

03.31: Comment period closes on the following SEC proposed rulemakings: Order Competition Rule; National Market System: Minimum Pricing Increments, Access Fees and Transparency of Better Priced Orders and: Disclosure of Order Execution Information

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