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OPINION

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Five US market regulation forecasts for 2019

Davis Polk lawyers expect changes to Volcker rule and guidance on cryptocurrencies

ANNETTE L. NAZARETH AND **GABRIEL D. ROSENBERG**

While the new Democratic-controlled House of Representatives makes legislative reforms in financial regulation very unlikely, we predict the financial regulators will continue to effect change in key areas.

1. Volcker rule reforms

The Volcker rule has been one of the most controversial markets-related regulations stemming from Dodd-Frank. Congress recently exempted community banks and made other small changes to the statute. Nonetheless, many flaws remain in implementing the rules, as evidenced in the debate around amendments proposed by the regulators in 2018.

There are likely to be some amendments in 2019, but their scope and content remain unclear. Of greatest impact will be the decision made on the proposed introduction of a new "accounting test".

In its proposed form, and absent any significant changes or exclusions, the test would drastically increase the scope of financial instruments subject to the rule. Market participants have warned that such an approach could decrease market liquidity, and have noted the disconnect between the proposal's accounting test and the short-term focus of the statute.

Expect significant debate on this issue, likely resulting in amended regulations that are better tailored to the statute. Most of the other amendments to markets-related provisions of the rule, such as changes to detailed market-making and hedging standards, will probably be finalised largely as proposed.

2. Further developments in regulation of digital assets

The early focus by US regulators on cryptocurrencies and digital assets was largely on fraud and manipulation. We are hopeful that a second wave of innovation in digital assets will facilitate the adoption of the technology more broadly.

These may include the possibility of short-dated futures contracts in bitcoin that function as a regulated spot market, new payments methods through stablecoins, and the development of compliant infrastructure to support offerings and trading of security tokens.

But these types of innovations will need some help from regulators, as the existing rules do not work neatly for digital assets, and regulatory uncertainty has made compliance with the requirements difficult.

For example, the Securities and Exchange Commission could provide guidance on key issues, such as how a broker-dealer can satisfy its custody and record-keeping obligations for on-blockchain assets, and how non-security assets such as bitcoin should be treated when held by a registered broker-dealer.

3. A fiduciary standard for broker-dealers

SEC chairman Jay Clayton likely has the votes he needs to adopt Regulation Best Interest, which will require brokers to only make recommendations and provide advice that serves clients' best interests.

It will also set new guidelines for broker-dealers to disclose and affirmatively mitigate conflicts of interest. The journey toward adoption of the regulation has been long, and a highly controversial attempt by the Department of Labor to apply its fiduciary rule to transactions with retirement account clients was overturned last year by the Fifth Circuit. Expect the regulation to be adopted largely as proposed.

4. Security-based swaps regulations finalised

The SEC is behind on implementing the Dodd-Frank provisions governing security-based swaps, but progress is finally in sight. The SEC has reopened the comment period for its previously proposed rules relating to capital, margin and segregation requirements for security-based swap dealers.

Adoption of those rules is an important predicate to the implementation of other requirements for security-based swaps. Expect all remaining rules to be adopted this year, and security-based swap dealers to be required to register at least six months thereafter — likely in early 2020.

5. Giancarlo races to the finish line

The White House's recent announcement that it intends to nominate Heath Tarbert, a senior Treasury official, as the next chair of the Commodity Futures Trading Commission (CFTC) may hasten the exit of the incumbent.

Chris Giancarlo's term is due to expire in April but he can remain in position until January 2021 or until his successor is confirmed by the Senate, whichever occurs earliest. With a leadership change possible within the next four months, expect Mr Giancarlo to work aggressively to act on a number of reforms.

High on his list of priorities include amendments to regulations related to swap execution facilities and rulemakings relating to Project KISS (a regulatory simplification project). Less certain is whether Mr Giancarlo will be able to move on much-anticipated cross-border rule proposals.

Of course, his ability to make tangible progress will depend in part on the length of the government shutdown and its fallout for the already budget-constrained CFTC.

Annette L Nazareth and Gabriel D Rosenberg are partners in the financial institutions group of Davis Polk & Wardwell, a global law firm