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SEC And CFTC Regulatory Priorities To Watch In 2020

By **Tom Zanki**

Law360 (January 1, 2020, 12:04 PM EST) -- Ahead of the 2020 presidential election, the nation's securities and derivatives watchdogs expect to move ahead with heightened urgency on long-awaited rulemaking proposals that could shape the legacy of the chairmen of both agencies.

The Securities and Exchange Commission and the Commodity Futures Trading Commission expect to tackle a busy regulatory slate in 2020. For the chairs of both agencies — Jay Clayton at the SEC and Heath Tarbert at the CFTC — this year could also be their final opportunity to leave their mark given the looming presidential election and potential change in administration.

While both bodies share certain concerns, including confronting regulatory challenges posed by the growth of digital assets, each have distinct priorities that appear ripe for action in 2020. Lawyers also note that regulators are facing a tight time frame to complete priorities given that the nation's attention will shift to the presidential campaign by Labor Day.

"It has to be things that they can accomplish in the next eight months," said Morrison & Foerster LLP counsel Marty Dunn, a former counsel and acting director of the SEC's Division of Corporate Finance.

Here, Law360 looks at regulatory matters to watch.

The SEC Could Rein in Proxy Firms

The SEC has signaled its 2020 priorities in recent months through proposals it has released for public comment, plus numerous speeches by Clayton and the agency's recent submission of its short-term regulatory agenda filed with the federal Office of Management and Budget.

Among the more contested battles on the SEC's menu is a proposal that would increase regulation of proxy advisory firms, which are third parties that sell voting advice to asset managers who own stakes in hundreds of public companies or more. Proxy firms like Institutional Shareholder Services Inc. and Glass & Co. have become influential in recent decades, given the growth in share ownership by institutional investors.

Critics argue that ISS and Glass-Lewis have become powerful players in corporate governance with little regulatory oversight, while defenders say proxy firms are simply selling non-binding advice to their clients on how to hold corporations accountable. Proxy firms offer voting advice on matters of board of director elections, executive pay and merger proposals, plus hot-button topics including climate policies and corporate diversity.

An SEC divided on party lines approved a proposal on Nov. 5 that would require proxy firms to improve disclosure of conflicts of interests, allow corporations to review and respond to proxy firm recommendations before a shareholder vote, and codify that proxy firms could be liable for fraud if they make materially misleading statements when attempting to influence votes. The SEC on the same day also submitted a plan to raise thresholds on shareholder proposals, increasing minimum requirements that haven't been adjusted for decades.

"The proposals are pretty middle of the road and I think they will be helpful," said Skadden Arps Slate Meagher & Flom LLP partner Brian Breheny, who previously served in the SEC's Division of Corporation Finance. "Clearly there are lots of people who don't agree."

Depending on one's view, the SEC's proposals are either sensible changes to reflect current market realities or concessions to corporate interests that object to the influence of proxy firms and shareholder advocates. The proposals also come as ISS is suing the agency, alleging that guidance that the SEC published before the agency's rule proposals on proxy advisory firms could impede its ability to deliver independent research.

Regardless, SEC action appears imminent. Comments on both proposals are due by Feb. 3, after which the agency could take action.

"My bet is that these [proposals] will become final rules in some sort of form next year," Haynes and Boone LLP partner Bruce Newsome said.

More Investors Could Gain Access to Private Offerings

The SEC wants to expand the definition of an accredited investor, which determines who can invest in private securities offerings not registered with the agency. The agency on Dec. 18 proposed adding various measures of sophistication to the definition beyond existing income and wealth tests.

Under an SEC proposal, people who hold Series 7, 65 and 82 licenses — credentials that allow individuals to do things like sell securities or provide financial advice — would be deemed accredited investors. The proposals would also expand the accredited investor definition to include individuals considered a "knowledgeable employee" at a money management firm, plus registered investment advisers, family offices and other entities would also qualify.

These changes would mark a departure from the current definition of an accredited investor, set in 1982, which currently rely solely on income and wealth criteria. A person must have at least $200,000 annual income or a net worth of at least $1 million, not including the value of their home, to be considered an accredited investor. The SEC is not proposing any changes to those levels, which have not been adjusted for inflation in 37 years.

The SEC is currently accepting comments on the proposal, which could be voted in 2020. The topic has become more controversial as the market for private offerings has grown to outstrip the public markets, though only certain investors can participate in this riskier segment.

The debate pits advocates who want wider access to private offerings on the premise that early-stage companies are now achieving most of their growth before they go public, versus skeptics who point out that private markets provide little disclosure and lack the investor protections of public markets.

However the SEC defines an accredited investor, lawyers expect there will be changes.

“The definition requires a refresh," Breheny said. "It’s been the same for a long time.”

The SEC asked whether it should revise the accredited investor definition as part of a 211-page “concept release” issued last June that sought public comment on whether changes are needed to simplify its regime for regulating private offerings.

The release also asked whether retail investors who are not accredited investors should be granted access to private offerings through “pooled investment vehicles,” which could provide them opportunities to invest in private equity or other unregistered offerings on similar terms as institutional investors. Clayton recently told the Senate that SEC staff is examining whether “appropriately structured funds can facilitate Main Street investor access to private investments.”

“That’s a laudable objective,” said Ropes & Gray LLP partner Keith Higgins, who is a former director of the Division of Corporate Finance. “Working out the details of it will be hard. But I do see that as something that the commission will work on.”

The SEC Could Scale Back Quarterly Reporting

President Donald Trump in August 2018 recommended in a tweet that the SEC end quarterly reporting requirements for public companies and switch to a six-month system, saying that top CEOs advised him that the move would save them money complying with regulations.

The SEC has not committed to doing away with quarterly reporting requirements for public companies, which has been standard practice since 1970. Investor groups quickly came out against the idea on grounds that investors need timely, accurate information to make informed decisions.

However, the SEC requested public comment in December 2018 on whether quarterly reporting rules should be eased and whether its current system encourages companies to spend too much energy on achieving short-term results. The agency followed up last year by hosting a roundtable on the topic. Clayton has said he wants to foster more long-term perspective in public markets.

Regulators have yet to propose anything, though potential changes to rules governing earnings releases and quarterly reports are listed on the SEC’s short-term agenda of priorities. Lawyers say they are not expecting the SEC to end quarterly reporting, though there may be ways to eliminate redundancies under current disclosure rules, especially for smaller public companies.

“I don’t think there is a lot of momentum, by and large, for less frequent reporting by companies,” Higgins said, adding that “you could look at streamlining the quarterly reports.”

New Derivatives Rules for Funds Are Likely

The SEC in November revived efforts to regulate how mutual funds and other investment companies can use derivatives, which are complex financial instruments that can increase returns, albeit at increased risk, in their portfolio strategies.

The agency said it wants to replace a patchwork system long in place whereby market participants have relied on SEC guidance or industry practice on a case-by-case basis. Adding urgency to the proposal is the fact that derivatives have grown in volume in recent decades.

“For a practice and market that is so important, we need a robust and evergreen regulatory framework,” SEC Director of Investment Management Dalia Blass said at a recent conference before securities lawyers.

The 459-page proposal would apply to registered funds, including mutual funds, exchange-traded funds and business development companies. Such funds would be permitted to use derivatives, such as futures, swaps and options, under certain conditions, including that the funds adopt a written derivatives risk management program and accept limits on the amount of leverage-related risk they can assume.

The SEC's latest stab at regulating funds' use of derivatives follows a 2015 proposal that would have allowed them to do so under stricter caps. But that effort never passed following complaints from industry groups that argued the proposed rules were too restrictive.

The CFTC May Finally Decide Position Limits

The CFTC, the nation’s principal regulator on derivatives, is also entering the year hoping to resolve lingering matters. Topping that list could be a proposal on position limits for certain speculative futures contracts.

The CFTC has sought to enact position limits since the 2010 passage of the Dodd-Frank law, which increased the agency’s regulatory powers in the wake of the financial crisis, but previous proposals have either been rejected by the courts or failed to pass. Position limits would prevent traders from cornering the market on certain physical commodities, while allowing “bona fide hedging” exemptions for legitimate business needs of producers, such as farmers.

Striking that balance has bedeviled the agency in the past.

“Defining that hedging concept has been contentious,” said Eversheds Sutherland counsel Ray Ramirez. “It gets pretty nitty gritty pretty quickly.”

That said, Tarbert has recently told industry groups that the CFTC plans to propose a position limits rule in the coming months that ensures that “bona fide hedging is not restricted.” Additional CFTC commissioners have also stated their intent to move forward on the matter.

“Position limits have been hanging over the industry for a very long time,” Foley & Lardner LLP partner Kathryn Trkla said. “There is perhaps an element of position limits fatigue and wanting to get that wrapped up.”

The CFTC Could Enact Cross-Border Swaps Rules

The CFTC is also moving forward on a proposal to regulate cross-border swaps, another unfinished priority that was mandated by the Dodd-Frank legislation a decade ago.

By a 3-2 vote, the CFTC on Dec. 18 proposed a rule that would govern when cross-border swaps should be registered with the agency. Swaps are a type of derivative by which parties exchange cash flows on a given asset, such as interest rates or currencies, in order to manage risk. Abuse of swaps is widely blamed for contributing to the global financial crisis.

The CFTC's proposal sets ground rules on when its regulations should apply to swaps booked abroad, such as through a foreign-based subsidiary of a U.S. bank, in order to protect American markets and taxpayers. The proposal also refrains from imposing CFTC regulations in foreign jurisdictions that have comparable rules to the U.S.

The CFTC proposal includes other exemptions, such as not applying additional regulations to firms that are already governed by the Federal Reserve. Tarbert said the proposal seeks to provide rule-based clarity to a market that until now has relied on informal guidance. However two CFTC commissioners, Rostin Behnam and Dan Berkovitz, dissented, citing concerns that the proposal would make it too easy for firms to evade U.S. regulations.

The proposal could be voted on in early 2020.

"The commission is trying to thread the needle of registration that is not over-reaching beyond our borders, yet sufficiently protects the interests of the U.S. and U.S. markets," Covington & Burling LLP counsel Anne Termine said. "This approach is not without controversy as the supporting and dissenting statements of each of the commissioners shows. And whether this approach of comity will be reciprocated by foreign regulators remains an open question."

--Editing by Jack Karp.