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LXR Group

Biweekly Bulletin

Bringing our clients and subscribers exclusive policy updates and analysis from the world of capital markets, fintech, investor protection and more.

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Featured:

Plus:

Analysis: The Impact of the Midterm Election on Financial Regulatory Policy

Although ballots continue to be counted in a handful of House races, and there is a December runoff in Georgia between Senator Raphael Warnock (D) and Hershel Walker (R), the makeup of the 118th Congress has largely come into shape. Democrats will remain in control of the Senate, meaning Sen. Sherrod Brown (D-OH) will stay atop the Senate Banking Committee. Republicans, having secured a very narrow majority in the House – having won at least 219 seats to the Democrats 211 – will take over control of the lower Chamber. This means that Rep. Patrick McHenry (D-NC) will gain the House Financial Services Committee gavel, and with it, a platform —and subpoena power— from which to hold hearings and launch investigations to undermine administration policies. LXR Group is pleased to share our preliminary analysis...

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Impact of the Midterm Election on Financial Regulatory Policy (Cont.)

The LXR Group is pleased to share our preliminary analysis of what these changes will mean for financial regulatory policymaking in the coming two years.

- ***Impact on the Senate Banking Committee.***

In the Senate, the election results – and the certainty that Democrats will retain their de-facto majority – mean that things will be largely steady-as-they-go.

Over the past two years, Senate Banking Committee Chair Sherrod Brown (D-OH) has shown a tendency to conduct oversight, rather than to push for legislative changes (presumably given the filibuster's 60-vote filibuster threshold), and we expect that largely to continue. The Banking Committee efforts in the 118th Congress are likely to be focused on ensuring investors are protected, that regulators have sufficient authority and funding to address problems, and that President Biden's nominees are swiftly confirmed. One lingering point of uncertainty relating to the Banking Committee in the 118th Congress hinges on the upcoming December 6th run-off in the Georgia Senate race. If Senator Warnock wins his run-off, this would give the Democrats a 51-49 Senate - and a *majority* of seats on the Banking Committee, speeding up the time it takes for the Senate to act on any given nominee or piece of legislation.

Sen. Tim Scott (R-SC) is in line to take over from retiring Sen. Pat Toomey (R-PA) as the top Republican on the Banking panel.

- ***Impact on the House Financial Services Committee.***

In the House, the extraordinarily narrow margin of the Republican's majority is likely play havoc on the chamber's ability to legislate with respect to policy, suggesting an inordinate emphasis on oversight and politically driven investigations. Like most House Committees during the 118th Congress, we expect that the HFSC will spend a substantial amount of its time and resources conducting oversight of the Biden administration and its appointed leaders of independent financial regulators.[1] In particular, we expect the SEC and CFPB to be in the crosshairs, with oversight of the CFPB's use of its supervisory authority over non-bank lenders, and oversight of the SEC's rules around climate and ESG disclosures, among the very first targets.

At the same time, in contrast to previous Republican Chair, Jeb Hensarling (TX), Rep. McHenry has shown a willingness to work across the aisle if it means he can accomplish some of his goals. We expect him to push legislation—especially around crypto—that is narrowly-tailored and sufficiently-bipartisan to move through a Democrat-controlled Senate.

The most likely starting point for McHenry's anticipated bipartisan legislative push is oversight of so-called Stablecoins. Both Republicans and Democrats agree that stablecoins, a type of cryptocurrency tied to the price of another asset such as the US dollar, need government oversight. Indeed, Rep. McHenry himself recently stated that that one of his top legislative priorities on the committee will be "giving clarity to the digital asset ecosystem."

The Digital Assets Working Group of Democratic members, created last year by Waters, is likely to continue its work focusing on cryptocurrency regulation and the possible creation of a US Central Bank Digital Currency. The Task Force on Financial Technology – established by Waters in 2019 – is likely to be reorganized. We believe it is possible that McHenry will opt to elevate the task force by formalizing its role as a new subcommittee. It is also possible that McHenry merges the Fintech Task Force with the separate Artificial Intelligence Task Force.

At the subcommittee level, unlike Democrats, Republicans do not typically defer to seniority in assigning subcommittee gavels. In fact, previous Republican chairs have made members effectively audition for the

role. That being said, we would expect that Rep. Bill Huizenga (R-Mich) will continue to serve as the top Republican – and thus the Chairman – of the HFSC's Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets. We also expect that Republicans may disband the Subcommittee on Diversity & Inclusion, or fold its legislative jurisdiction into the jurisdiction of another subcommittee.

Finally, we would not be surprised to see the overall size of the HFSC expanded, potentially by as much as 5-7 seats.

- ***Lessons from the JOBS Act of 2012.***

The House Republican Leadership's explicit decision to emphasize oversight of the Biden Administration does not necessarily preclude the potential for significant legislation with regard to financial services regulatory policy. To the contrary, financial services policy has proven to be one of the relatively few areas where Republicans and Democrats have managed to find common ground over the past decade, especially during periods of divided government.

The most instructive template for this type of action was arguably set out by the JOBS Act of 2012. In that instance, a GOP-controlled House, a Democrat-controlled Senate, and a Democratic administration came together to enact the arguably the most notable capital markets deregulatory legislative package since the 1990s. Passage of the bill was made possible by a political balance that encouraged negations directly between the Obama Administration and House Republicans – with the negotiated package ultimate receiving a decisive lift from Senate moderates, who successfully pushed the Senate to take up and pass the legislation prior to the 2012 election, over howling objections and protests from progressive Senators, along with stakeholders representing organized labor, consumer advocates, and state securities regulators.

Subsequent Republican majorities have on several occasions sought to replicate the political chemistry that led to the 2012 deregulatory law. In Spring 2018, a similar coalition of Republicans and moderate Democrats used techniques to muscle through a modest package of bank deregulatory measures, known as the "Crapo bill." Later that same year, in the waning days of the last Republican House majority, then HFSC Chair Jeb Hensarling (R-TX) sought to reprise the success of the JOBS Act; he partially succeeded, with the House voting overwhelmingly to approve legislation known as "JOBS Act 3.0" sponsored by himself and Rep. Maxine Waters (D-CA). Despite the JOBS Act 3.0 overwhelming passing in the House, the clock ran out on this effort. More recent efforts to duplicate the success of the JOBS Act – including a dead-on-arrival effort by Senate Banking Committee Ranking Member Pat Toomey (R-PA) in April, 2022, have been less successful.

LXR Group will be paying close attention to moderate Democrats on the Senate Banking Committee, including Sens. Mark Warner (D-VA), Kyrsten Sinema (D-AZ) and John Tester (D-MT), particularly as it relates to areas where there is bipartisan appetite for policy reform. Foremost among such areas is policy related to the regulation of digital assets. Other potential areas for GOP-driven compromise include housing policy and structural tweaks to the CFPB.

- ***Democratic Leadership Transition in the House.***

We would be remiss not to mention the very significant fact that the 118th Congress will usher in a new Democratic leadership team for the first time in a generation.

On November 17, Democratic Speaker Nancy Pelosi announced her intent to retire after more than 20 years as the leader of the House Democratic Caucus, which has included 8 years of service as Speaker of the House (2007-2011, 2019-present). Shortly after Pelosi's announcement, the longtime second and third ranking House Democrats — Majority Leader Steny Hoyer (D-MD) and Whip Jim Clyburn (D-GA) — let it be known that they, too, will step aside (though Clyburn intends to remain in leadership as Assistant Democratic Leader). It is expected that they will be replaced, respectively, with Reps. Hakeem Jeffries (D-N.Y.), Katherine Clark (D-Mass.) and Pete Aguilar (D-Calif.). The LXR Group will share our insight on the new Democratic leadership triumvirate, and the implications for financial services policy, at a later date.

Top Policy Developments:

Collapse of FTX Shakes Crypto Ecosystem, Resets Terms of Debate over Regulation.

As we recently explained in detail on the LXR Blog, the collapse of FTX just three weeks ago shocked the financial world, and the fallout continues.

In the time since our previous post, crypto markets dropped by more than $190 billion since the collapse, and recent reports include that a backdoor in FTX's systems was coded to enable assets to exist on both FTX's and Alameda's balance sheets simultaneously. Contagion is appearing all over the crypto ecosystem, with other exchanges saying they do not expect assets held with FTX to be recovered. Fortunately, much of the chaos caused has been kept out of the traditional financial system; banks and other financial institutions do not appear to have been affected thanks to efforts by regulators to limit traditional financial institutions' exposure to the assets.

It remains unclear how much FTX's collapse affects U.S. customers. By law, U.S. residents were only permitted to trade on FTX's U.S. subsidiary, a derivatives exchange regulated by the CFTC. But it is clear that some U.S. residents were able to trade on FTX International. The extent of their losses is likely to come out in bankruptcy and future litigation. Compounding the confusion is the abysmal condition of FTX's balance sheet – recently characterized by one financial reporter as "an Excel file full of the howling of ghosts and the shrieking of tortured souls."

What *is* clear is that U.S. investors in FTX and Alameda were misled or outright scammed, demonstrating once again the flaws with the U.S.'s private capital markets regime. Without public market regulations, the disclosures that Alameda offered to investors was negligible and faulty. Clearly, the lack of disclosures in private capital markets harms investors; venture capitalists are writing their investments down to $0.

Equally concerning is that the staggering level of apparent deception perpetrated by former crypto king Sam Bankman-Fried wasn't uncovered by government investigators, nor even by investigations involving the financial media ecosystem.

Further, since FTX's bankruptcy filing, SBF has compounded questions about why regulators and investors failed to see "red flags" by putting out weird tweets, giving terrible interviews to reporters, and appearing shockingly oblivious to the weight of the situation and its consequences.

On November 16th, it was reported that *Empire Consulting Group* had terminated its contract with the U.S. arm of FTX last week, according to a disclosure filed this morning, leaving the embattled crypto exchange without any hired guns in Washington amid a tidal wave of scrutiny. The exchange's other outside lobbying firms, *Conaway Graves Group*, and *Rich Feuer Anderson*, dropped FTX the previous week.

On November 18th, outgoing HFSC Chairwoman Maxine Waters (D-CA), and incoming Chairman Patrick McHenry (R-NC), jointly announced a bipartisan hearing into the collapse of FTX and the broader consequences for the digital asset ecosystem. The announcement said the HFSC "expects to hear from the companies and individuals involved, including Sam Bankman-Fried, Alameda Research, Binance, FTX, and related entities, among others." The Senate Finance Committee is also reportedly planning a hearing.

Senate Agriculture Committee Scraps Planned November Markup of Crypto Legislation Supported by FTX, CFTC. Announces Oversight Hearing for December 1st.

On November 21, one week after cancelling a planned markup of the bipartisan Digital Commodities Consumer Protect Act of 2022, the Senate Ag Committee announced that instead of marking up legislation, it would instead hold a hearing on Dec. 1 to examine the sudden collapse of FTX.

The Ag Committee's decision to cancel the planned markup came days after the Committee's top Republican, Sen. John Boozman of Arkansas, called for a "top-down" revisiting of his crypto regulation bill, which was expected to be considered and passed by the Committee later this month. "The events that have transpired this week reinforce the clear need for greater federal oversight of the digital asset industry," Boozman said in a

statement. "In light of these developments, we are taking a top-down look to ensure [the bill] establishes the necessary safeguards the digital commodities market desperately needs."

The lone witness at the hearing, entitled "Why Congress Needs to Act: Lessons Learned from the FTX Collapse," is Rostin Behnam, the chairman of the CFTC.

Behnam has lobbied for greater authority for his agency for months. In his testimony, he alluded to alleged conflicts between the CFTC and SEC when he dismissed talk of a "power grab." Interagency cooperation is not new and will continue, Behnam said. Extending CFTC authority is "about filling a gap."

On the Hill.

Committee Leadership for 118th Congress takes Shape. When the new Congress convenes on Jan. 3, key House and Senate committees will have new leaders, with retirements being the driver of most of the expected changes.

In the Senate, seven Senate committee leaders are retiring, including six Republicans. Of particular significance is the retirement of both Party's leaders on Senate Appropriations Committee; this will set off a cascade of changes on other panels.

Probable Senate Committee Chairs and Ranking Members in the 118th Congress.