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The Impact of Midterm Election Results for Financial Services

By FTI Financial Services Public Affairs Team

With the economy and social issues at the forefront of voters' minds going into the November midterms, financial services took a back seat to the pressing issues facing the electorate. However, this does not mean the financial services industry is immune from the election's outcome. In fact, the newly divided Congress, with Republicans in control of the House and Democrats holding the Senate and Presidency, will have significant implications for the broader financial services industry.

While the exact makeup of Congress has yet to be determined, Republicans will be in the majority in the House of Representatives next year.[1] But Republicans will only have control over one chamber – leading to conflict with the Democrat-led Senate and the Biden Administration. This divided government will hamstring their ability to make their priorities law. However, they will have a bully pulpit to message and refocus the conversation and above all, have their own levers of authority and oversight over the financial services industry and its regulators.

The new makeup of Congress also means new leadership in several committees and party rankings. One of the most significant impacts will be the incoming House Financial Services Committee Chairman Patrick McHenry (R-NC). Chairman McHenry's priorities include digital assets regulation, ESG oversight, and countering China's global influence, among others. On the Senate side, with Senate Banking, Housing, and Urban Affairs Committee Ranking Member Pat Toomey (R-PA) retiring, Senator Tim Scott (R-SC) will become the most influential Republican on the Committee. Outside of championing financial inclusion, Senator Scott's priorities are less known. Additional significant leadership changes include the new House Majority Whip, Congressman Tom Emmer (R-MN), and Ranking Member of the House Oversight and Reform Committee, a position with three contenders and counting.[2] Senator Sherrod Brown (D-OH) will remain chairman of the Senate Banking Committee.

To help the financial services sector understand the new balance of power, FTI Consulting lays out how the leadership changes will impact the financial services industry, alter the priorities, threats, and risks, and what comes next for financial services.

Digital Assets

In 2022, we saw numerous legislative proposals and policy recommendations across the digital assets landscape: stablecoin regulation, federal agency oversight, Bitcoin 401(k) offerings, and more. While none of these measures proceeded, many of them will serve as the foundation for the next Congress, as digital assets remain a topic of interest. Incoming House Financial Services Committee Chairman Patrick McHenry (R-NC) repeatedly ranks digital asset regulation as a top priority, particularly stablecoin regulation, digital asset definitions, and exchange rules.[3] However, with the continuation of Senator Brown as chairman and the retirement of a vocal digital asset supporter in Ranking Member Toomey, working on bicameral legislation or even advancing bills in the Senate will remain a challenge.

While Congress, the Biden Administration, and federal agencies have debated an array of issues covering the broad digital asset ecosystem, the most anticipated legislation is related to stablecoins. Despite agreement on the importance of stablecoin legislation, incoming Chairman McHenry and outgoing Chairwoman Maxine Waters (D-CA) highly anticipated bill on the subject never made it to markup. Both members plan to continue working on pain points around the storage of assets and unhosted wallets, while ensuring the Biden Administration is supportive.[4]

The new Congress will face added urgency to pass crypto regulation in the wake of the quick collapse of the crypto-exchange FTX—with policymakers and regulators from both sides of the aisle calling for increased oversight and legislation. Lawmakers from House Financial Services, Senate Banking, Housing, and Urban Affairs, and Senate Agriculture Committees are all convening public hearings on the crypto exchange's fallout.[5]

Policymakers will remain focused on the digital asset market as the nascent industry's growth and volatility is complex and challenging. Despite the influx of legislation, letters, hearings, and more on digital assets, the lack of any digital asset legislation highlights the continued education gap and the long road ahead for Congress to send legislation to the President's desk.

Oversight of ESG with a Climate Focus

While a divided Congress will limit legislative activity, the Republican-led House will likely lean on its oversight authority to investigate financial services firms that have strong record on environmental, social and governance (ESG) investing. With climate and social issues as the main issue of ire for Republicans, they will seek to make the connection that firms are driving ESG investment considerations solely because of a political ideology and not in the best interest of their clients.[6]

This year saw a groundswell of state level activity against firms with strong ESG records. From red-state divestment coalitions to emerging thought leadership from the likes of *Woke, Inc.: Inside Corporate America's Social Justice Scam* author Vivek Ramaswamy, State Financial Officers Foundation, and Consumers' Research, the anti-ESG narrative has permeated and risen to the federal level.[7] In a recent interview, Rep. Garland "Andy" Barr (R-KY), a member of the House Financial Services Committee, called ESG a "cancer within our capital markets."[8]

While Republicans may be limited in legislating on these issues, they will have oversight authority to conduct investigations and control the media narrative, with the potential to cause damage to financial services companies' reputations and ultimately, their bottom line. We expect as early as Q1 2023 for House Republicans to call financial regulators and business leaders who have been proactive on incorporating climate risk into disclosures. Our view is that asset managers, who have already been the targeted by Republican members, as well as banks are most at risk for this level of scrutiny, followed by the insurance industry.

A case in point: at a September hearing [9] several bank CEOs were intensively questioned by Republicans, who characterized their climate investment strategies as "woke" and pushed the CEOs to take a defensive posture. Previously, the banks were in full promotion mode to tell their ESG story and the only scrutiny they feared was of greenwashing or not doing enough to divest fossil fuel investments. In 2023, banks will face a paradox as they seek diffuse negative criticism from Republicans in Congress while complying with Biden Administrative prerogatives such as the Federal Reserve's pilot climate analysis exercise to test the six largest banks' resilience to climate-related stress scenarios. Republicans are already and will continue to be skeptical of the process as it discourages investment in the energy industry.

Biden Administration Aggressive Enforcement and Oversight Continues

With slim majorities in Congress likely to lead to a lack of productive legislating on Capitol Hill, financial services regulators will remain powerful enforcement agencies. In 2022, the SEC and Commodity Futures Trading Commission (CFTC) stepped up enforcement actions—particularly on digital asset firms and businesses' ESG marketing and disclosures. Consumer Financial Protection Bureau (CFPB) Director Rohit Chopra has also flexed his enforcement muscle and has been very vocal about his policy priorities this upcoming year.

Director Chopra's heavy enforcement arm will likely not slow down next year. His recent restructuring of the agency's Office of Innovation indicates his hesitation towards offering new, innovative financial companies a regulatory harbor that gives companies "special regulatory treatment." In its place, Director Chopra created the Office of Competition and Innovation, sending a clear signal that the risks associated with the rapid growth of the fintech industry is something the CFPB is looking at closely.[10] It is expected that the CFPB will increase its scrutiny and take enforcement action against fintech firms that fall short of their obligations.

Moreover, a consistent theme throughout Director Chopra's tenure has been his concerns regarding Big Tech, particularly in relation to consumer privacy, companies' monetization of consumer data, and fraud in real-time payments. He has mentioned that these policy areas will continue to be high on his priority list in terms of both regulation and enforcement. As more consumers raise concerns over Buy-Now-Pay-Later (BNPL) products, Director Chopra will continue to focus on the regulation of BNPL—with the possibility of the BNPL companies facing similar regulations to the credit card industry.[11]

The CFPB has always been a controversial office for Republicans, and Director Chopra's aggressive and broad scope will face heightened attention following the midterms. In October, the 5th U.S. Circuit Court of Appeals ruled that the design of the CFPB violated the Constitution because it receives funding through the Federal Reserve, rather than appropriations legislation passed by Congress.[12] This ruling and Chopra's broad reach will come under scrutiny in the new Congress as the Republican controlled House will likely increase oversight and hearings of Chopra and the Bureau.

Two areas of focus for SEC enforcement this year were the digital asset space and ESG-related issues. This has led stakeholders to accuse the SEC of "regulating by enforcement" as the digital asset industry awaits regulatory certainty.[13] The SEC will continue to aggressively enforce securities law in the digital asset ecosystem, with SEC Chairman Gary Gensler stating he would take the SEC's "authorities as far as (it can) go" to address the lack of investor protection in the space.[14] Chairman Gary Gensler's points were reinforced in a recent Financial Stability Oversight Council (FSOC) report, which said the regulators view compliance and enforcement of existing regulation as critical to addressing the industry's risks.[15]

While many members of the digital asset industry view the CFTC as the friendlier agency, the CFTC has also announced its share of enforcements in the space. On October 20, the CFTC released its annual enforcement results, which stated that the agency filed 83 enforcement actions related to digital assets in 2021.[16] At a DC Fintech Week event in October, CFTC Chair Rostin Behnam warned that the CFTC would not be the kinder regulator and said for "for anyone out there who's participating or who's creating and innovating, don't expect this to be a free pass." However, Behnam noted that his agency will continue working with the industry to support innovation.[17]

Private Equity as an Evergreen Target

Economic instability and persistent efforts to paint the private equity industry as a villain are driving increased political risk. The industry continues to be attacked and blamed for societal ills from real estate pricing, climate risk, and hospital and nursing home conditions. While private equity has its singular champions and adversaries, it is also is an area of financial services that often flies under the radar and escapes serious political threats, despite a frequently negative media narrative.

In 2022, the private equity industry faced its closest political threat in years during the consideration of the *Inflation Reduction Act*. With the Senate's slim Democratic margin, the bill was held up over a provision to raise taxes on private equity by eliminating the "carried interest loophole," which refers to the lower tax rate private equity currently pays on certain portions of its income. Senator Kyrsten Sinema's (D-AZ) efforts to protect this tax provision came from her assertion that small and mid-sized companies would be exposed to higher taxes if this provision was repealed.[18] The last-minute changes to exclude this provision from the bill was viewed as a significant victory for the private equity industry.

But private equity is not immune from future attempts to raise revenue especially as the United States is teetering upon an economic slowdown or even a recession. Congress will always be looking for a shiny "pay for," or a provision that raises revenue to fund other priorities, and next time around private equity may not have the same leverage. The private equity industry needs to make a more authentic and compelling case about its value in Washington on the broader economy but more granularly, on its role in with respect to preserving or creating jobs.

Impact of Geopolitical Risks

While divided government will usher in a new era of partisanship in some regards, the strong bipartisan support from both policymakers and regulators to hold China accountable will continue throughout the lame duck and into next Congress. For financial services, the capital markets and securities space will see the brunt of the legislative and regulatory activity. In August, the U.S. and China reached an agreement allowing the Public Company Accounting Oversight Board (PCAOB) to inspect China-based audits of companies on U.S. exchanges. SEC Chair Gensler and many in the financial services and national security communities have expressed cautious optimism that such a deal will ultimately pan out.[19]

As a result, the *Accelerating Holding Companies Accountable Act*, which passed the Senate unanimously, could come up for consideration in the House as early as the lame-duck session. If signed into law, Chinese companies would only be afforded two consecutive years of noncompliance with US audit and disclosure requirements before being kicked off US exchanges, down from three in the previously—and unanimously—passed *Holding Foreign Companies Accountable Act*.[20] In a recent Senate Banking Committee hearing, SEC Chair Gensler expressed his support for the bill to gain negotiating leverage with China.[21] This will continue to be a priority moving forward.

Conclusion

FTI Consulting's Public Affairs team is well prepared to assist companies through these political changes. Our team is comprised of policy experts who have served in high profile roles within the White House, federal financial regulators, Capitol Hill staffers and Beltway media, allowing us to leverage our experience and intelligence for clients. Our team builds public affairs campaigns that monitor for political risk and proactively engage behind the scenes with third parties to promote and defend our clients' business interests in Washington.

Working with our government affairs team, we are well positioned to assist the digital asset industry to shape the upcoming legislation and regulation. Our ESG expertise combined with our asset management and banking expertise is already proving valuable to clients attempting to navigate the delicate balance of responding to ESG policy needs and expectations while at the same time mitigating political attacks. For these and other issues, protecting a company's reputation in Washington will be vital at this pivotal moment of political change.

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