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WASHINGTON POLICY STRATEGY

Potomac Perspective

The now-resolved debt ceiling standoff crowded out most other policy debate in Washington. With that legislation having passed, we turn our attention to a long list of issues that are likely to confront investors and management in the second half of 2023. This note looks at the prospect of a government shutdown, defense spending and aid for Ukraine, rules on investments in China, the student loan forgiveness case before the Supreme Court, corporate tax issues, mergers & acquisitions (M&A), and financial services regulation (including cryptocurrency).

LOWERED ODDS OF A GOVERNMENT SHUTDOWN (BUT NOT ZERO)

The debt ceiling bill established incentives for Congress to pass the 12 annual appropriations bills by the end of the calendar year. The government's fiscal year actually ends on September 30, but passing all the appropriations bills by then seems to be an unrealistic goal. If appropriations bill are not passed by December 31, 2023, a Continuing Resolution (CR) would automatically kick in on January 1, 2024. This would reduce discretionary spending for both defense and nondefense budgets.

The expectation was that Congress would pass a Continuing Resolution to fund the government past September 30 until it could pass the appropriations bill. **Although the debt ceiling bill's framework for the fiscal year 2024 spending bills reduced the odds of a government shutdown in the fall, it did not eliminate those chances entirely.**

Some House Republicans, who are upset with the debt ceiling deal, could try to block a CR or the appropriations bills in order to address some of their complaints regarding the debt ceiling increase. Although the conservatives probably lack the votes to block the spending on the House, they could make life miserable for House Speaker Kevin McCarthy by turning up the pressure on him from the Republican base. The dynamics in the House mean that a government shutdown in the fall is not impossible, although it is less likely than it was a few months ago.

DEFENSE SPENDING AND UKRAINE

Defense hawks in Congress criticized the debt ceiling agreement for increasing the defense budget by only 3.3 percent (defense and non-defense budgets would be cut by one percent if appropriations bills are not passed by January 1, 2024). The hawks could seek a supplemental increase in the defense budget later this year as part of additional aid for Ukraine. However, House Speaker Kevin McCarthy seems opposed to approving more for defense than what was agreed to in the debt ceiling bill. He could also be constrained by House conservatives who are upset that the debt ceiling deal did not include deeper spending cuts and who are more skeptical of the need for increased defense spending than are Senate Republicans. **Any vote to increase defense spending could create unique alliances between progressive Democrats, who opposed the debt ceiling agreement's increase in defense spending while cutting nondefense discretionary spending, and conservative Republicans (especially in the House) who have argued either for the end of aid to Ukraine or reduced military spending.**

CHINA OUTBOUND INVESTMENT RULES

The Biden administration has been preparing an Executive Order (EO) that would create a process to vet outbound investments in

China which would be similar to the process conducted by the Committee on Foreign Investments in the United States (CFIUS), which vets inbound investments made in the U.S. **An EO regarding outbound investments in China would likely be limited to industries closely related to national security such as advanced semiconductors, artificial intelligence, and quantum computing.**

A bipartisan group of senators is working on a broader approach which would vet investments tied to "Taiwan, technology development, digital assets, export controls, and other issues", according to Senate Banking Committee Chairman Sherrod Brown (D-Ohio).

Some free-market Republicans prefer a narrow approach to any type of vetting process and they could try to block efforts to pass a broad outbound investment bill. However, **given the competition as to which party can look toughest on China, the effort of the bipartisan group of senators bears watching.**

SUPREME COURT OF THE UNITED STATES AND STUDENT LOAN FORGIVENESS

Sometime in the next four weeks, the Supreme Court will probably announce its decision regarding the Biden administration's student loan forgiveness plan. Under President Biden's executive order, borrowers earning less than $125,000 a year ($250,000 for couples who filing jointly) would be eligible for up to $10,000 in loan forgiveness. Pell Grant recipients would be eligible for an additional $10,000 in debt relief. The administration cited the Higher Education Relief Opportunities for Students Act, which allows relief to student loan borrowers when there is a "national emergency." **Recent Supreme Court rulings have, however, been curtailing executive and administrative powers except when the authority is clearly and explicitly granted by Congress. Based on these recent case decisions and the oral arguments presented in this matter (which were held in February), it seems likely that the Court will block the administration's plan.**

BUSINESS TAX LEGISLATION

As we noted in recent notes on the debt ceiling, the agreement sets up a potential showdown in 2025 when the debt limit suspension ends and parts of the 2017 tax cuts expire. In the meantime, there have been discussions to suspend some business-related tax changes from the 2017 tax law. Last year, **the formula to determine the 30 percent cap on the business interest deduction changed which further limited the deduction**. Also, **the immediate expensing of R&D costs switched to a five-year deduction**. Congressional Republicans have been pushing to suspend these changes at least temporarily. However, Democrats want to use any changes in corporate taxes as a means to expand the Child Care tax credit.

M&A

The Department of Justice and the Federal Trade Commission have been considering changes to their merger guidelines for over a year. When the new guidelines are proposed, we expect them to refocus on different stakeholders rather than the prevailing focus on "consumer welfare." A new focus of antitrust guidelines could include the public (broadly defined), workers, and small businesses. As part of the recalibration of merger guidelines, the Biden administration could also propose lowering the Herfindahl-Hirschman Index (HHI) which is used to determine market competitiveness.

BANKING REGULATION

The first of what could be several steps to change banking regulation is likely to occur within the next few weeks**. The first step in the sequence of regulatory changes is likely to be part of the Basel III endgame and could propose changes in market and operational risk exposures.** The proposal would be targeted at banks with more than $100 billion in assets and with capital markets intensive businesses. The forthcoming proposal could also incorporate at least one change geared at the recent situation in the banking system. It could disallow banks with over $100 billion in assets from opting out of including most elements of accumulated other comprehensive income (AOCI) in regulatory capital.

Following this proposal, the banking regulators could also issue separate proposals that would:

- Make additional modifications to the tailoring regime (including requirements for total loss absorbing capital, stress testing, resolution planning, and liquidity rules)
- Impose comprehensive changes in bank capital requirements (pending on ongoing review of capital rules being conducted by the Federal Reserve Board)
- Effect alterations in bank merger rules which could coincide with proposals from the DOJ and FTC regarding mergers in other sectors.

DEPOSIT INSURANCE/WARREN CLAWBACK LEGISLATION

Related to the recent bank failures, proposals to increase deposit insurance have been floated on Capitol Hill. Currently, there **seems to be only limited political will to change deposit insurance coverage**. As time goes by since the last failure on May 1, the pressure to act has faded. Any subsequent bank failures could reignite the debate but, for now, the chances of passing deposit insurance legislation are low. If the situation changes and Congress considers a deposit insurance bill, it would also **open the door to a bill sponsored by Senator Elizabeth Warren (D-Massachusetts) to expand the ability of regulators to clawback compensation from executives at failed banks. Absent a deposit insurance bill, the prospects for a Warren bill also seem weak.**

SAFE BANKING

The situation in the banking industry pushed the SAFE Banking Act to a back burner. However, **it is possible that the Senate Banking Committee might markup SAFE in July with the intent of adding the bill to a "must-pass" year-end bill such as the National Defense Authorization Act (NDAA). House Republicans do not view the bill as a priority, so it is unlikely a House version of the bill will move through that chamber, but attaching SAFE to a bill like the NDAA could improve the bill's chances.**

MIFID II

Recently, the House Financial Services Committee passed a bill that would require the Securities and Exchange Commission to extend its no-action letter regarding the Markets in Financial Instruments Directive 2014 (MiFID II), which requires the unbundling of trading execution fees from research costs. The SEC's no-action letter is scheduled to expire on July 3, 2023. While **legislation to extend the letter's no-action relief is unlikely to pass both the House and Senate, the House could vote on the bill in the coming weeks, which could give the SEC political cover to extend the letter's protection.**

CRYPTOCURRENCY

Most of the policy action related to digital assets is likely to remain with the regulators and the courts. House Republicans recently released a draft bill on crypto market structure which would clarify jurisdictional issues regarding which agencies regulate various digital assets. However, congressional Democrats seem skeptical about the legislation, and without broad bipartisan support, the bill's chances of passing are remote. In the absence of legislation from Congress, investors and industry participants should continue to watch for enforcement actions. The recent lawsuits brought by the SEC against Binance and Coinbase will provide a roadmap for the regulatory pathway forward.

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