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FINANCIAL SERVICES REGULATORY REFORM UPDATE

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Next week will mark the return of both chambers of Congress to the Hill, as the Senate wraps up its last days of recess and members gear up for the 112th Congress to be under way. Although we are starting to see a trickle of new bills being introduced and hearings scheduled, for the most part these first few weeks tend to be reserved for staff transitions, strategizing, and finalizing committee membership and subcommittee leadership. We expect the Senate to finally pass an organizing resolution next week that will, among other things, set the committee ratios. Additionally, both parties held member retreats in the past weeks to formulate their goals for the upcoming year and discuss policy issues, and President Obama spoke at the Democrat conference in Maryland, at which the media was not allowed.

While we await, and fully anticipate real action on the Hill, this past week saw the tolling of the six months post enactment of Dodd-Frank. With this milestone came the deadline for the completion of quite a few reports, some of which are discussed below, and really kicks into high gear some of the more complicated components of the implementation of the law.

Additionally, we saw a preview of perhaps one area where some Democrats will work with Republicans to “tweak” a component of Dodd-Frank, when one of the namesakes of the law indicated a willingness to work with his Republican colleagues on fixing the interchange issue created by the “Durbin Amendment.” Although this statement generated a lot of news, it appears to be more of a one-off and not indicative of a broader willingness by Frank, and other Democrats, to reopen the majority of Wall Street Reform.

FSOC APPROVES NEW VOLCKER METRICS AS STARTING POINT FOR REGULATION

Earlier this week, the Financial Stability Oversight Council (FSOC) released its study on the Volcker Rule, in which it called for new quantitative metrics to determine which trading activities are proprietary, and for regulated banks to develop compliance strategies by which corporate officials could be held liable for violations. The release of this report triggers a nine month countdown for the various regulatory entities (the Federal Reserve, the SEC, the CFTC, the FDIC and the Office of the Comptroller of the Currency) to come up with the regulations necessary to implement Volcker.

It is worth noting that the FSOC metrics may not identify banned trading activity perfectly, but would at least recognize areas that would require further examination based on trading frequency and volume. Implementing the Volcker Rule “will be a complex assignment,” as an official from the Treasury for Financial Markets stated to the Financial Stability Oversight Council (FSOC) earlier this week, and one that will be even more difficult as House Republican attempt to stymie the process. The Treasury official

also commented to the FSOC that one of the top challenges will be distinguishing between illegal proprietary trading and permitted trading activities that are crucial to market liquidity, including market-making. Market-making involves firms acquiring a number of shares in a particular financial instrument so as to facilitate trading in that security among customers and to provide overall market liquidity.

FRANK TO SUPPORT CHANGES TO FED'S INTERCHANGE FEE PROPOSAL

Proposed debit interchange fees by the Federal Reserve, which would reduce annual revenue for U.S. banks by more than \$12 billion, have provoked strong reactions from Republicans and the industry, who want to overturn the Fed's rules if enacted. The proposed rules, which are implementing a mandate under Dodd-Frank to cap debit interchange fees charged to merchants, would do so at a flat 12-cent rate for each transaction. The rule is scheduled to be finalized by April 21st and in effect on the one year anniversary of Dodd-Frank's enactment (July 21st).

On Thursday, Rep. Barney Frank, the ranking member of the House Financial Services Committee and one of the co-authors of the Dodd-Frank legislation, somewhat surprisingly stated in an interview that "if [the Republicans] want to do something on it, I'll work with them." Frank had previously indicated that he was never a full supporter of the interchange rules in the Wall Street Reform bill, and we are not taking his statement to indicate anything beyond his willingness to work with Republicans on this one issue. However, it could be indicative of future opportunities to make "technical changes" to other parts of Dodd-Frank on a case by case basis, if other Democratic leaders are willing.

Even if House legislators are able to reach an agreement on overturning the Fed rules, they will face an uphill battle against the Democrat-controlled Senate. The second-most powerful Democrat in the Senate, Sen. Dick Durbin (D-IL), was the lead proponent of the interchange fee language in Dodd-Frank. According to one of his staffers, "legislative attempts to change the interchange law are premature and have no chance of ever passing Congress," and that this is "a debate we're happy to have" in terms of protecting small businesses and their customers against big banks and card companies. We hear that this fight will begin in earnest when the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will have a hearing on interchange fees next month.

HOUSE WAYS AND MEANS COMMITTEE HOLDS HEARING ON TAX REFORM

On Thursday, the House Ways and Means Committee held a hearing to examine the economic and administrative burdens imposed by the current structure of the federal tax system. The hearing was well attended by members, and the panel included representatives from the National Taxpayer Advocate, the Business Roundtable, Hudak & Company, the American Enterprise Institute, and Tax Analysts. Republicans present argued that the U.S. has the highest corporate tax rate of any given country (assuming that Japan cuts its corporate tax rate by 5%, as planned), and Democrats responded that there are incentives and tax breaks in the Internal Revenue Code that diminish the actual taxes paid by corporations. Panelists noted that the U.S. is one of the only remaining developed countries to tax companies on repatriation taxes, and also brought up the lack of long term certainty that exists within the current U.S. tax code. Overall there seemed to be agreement that the tax code is in need of simplification, tax reform is necessary for both individual and corporate tax regimes, and that all of these changes should reflect the current debt crisis in the U.S.

NEUGEBAUER QUESTIONS WARREN AND CFPB

On January 18, Rep. Randy Neugebauer, subcommittee chairman of Financial Services' Oversight and Investigations, sent a [letter](#) to Elizabeth Warren, head of the Consumer Financial Protection Bureau (CFPB), expressing his skepticism of the bureau's existence and demanding details on how it will operate.

Neugebauer has identified oversight of the Dodd-Frank Act as his top priority for this Congress and the letter marks his first specific query in the new Congress. The letter requested that Warren answer three pages worth of questions and asked for details on all meetings between Warren and the SEC, the Fed and other institutions. Neugebauer also asked Warren to explain how she intends to avoid stifling over-regulation. This letter likely foreshadows the frequency in which Warren will be called to the Hill to defend the CFPB from Republican, and potentially some Democratic, attacks.

POTENTIAL DELAYS TO CFPB RULEWRITING

An important provision of the Dodd-Frank Act has the potential to significantly delay the rule-writing process at the new Consumer Financial Protection Bureau (CFPB) and create another avenue for challenges from small firms. All federal agencies are required to assess the potential economic impacts of rulemakings on small entities under the Regulatory Flexibility Act. However, the CFPB will be one of only three agencies that will also have to comply with special rule-review procedures of the 1996 Small Business Regulatory Enforcement Act (SBREFA), due to an amendment that was added to the legislation at the request of Senator Snowe (R-ME).

This means that all CFPB rules will be scrutinized by a small business advocacy review panel before being released for public review. When a CFPB proposal is deemed to have a significant impact on a substantial number of small entities, agency officials must notify the Small Business Administration. The SBA's Office of Advocacy will recommend representatives from small business to be consulted. In the financial services arena, the represented entities will be among the 71,000 small-sized mortgage lenders and brokers, real estate settlement services, "buy-here, pay here" auto lenders, check cashing companies, payday lenders, credit repair agencies, collection agencies, pawn brokers, and even prepaid funeral providers. The CFPB is not required to adopt panel recommendations but agencies are historically receptive to changes.

This so-called "speed bump" means that the CFPB will have the added challenge of vetting the potential impact of proposed rules on the 'cost of credit' for small businesses. The small business review panels will provide specific alternatives to minimize any increases to the cost of credit.

SEC REPORT FINDS INVESTMENT ADVISER OVERSIGHT INSUFFICIENT

Under Dodd-Frank, the SEC was required to conduct a self-assessment of its ability to comprehensively examine advisers. In its [report](#) released this week, the SEC recommended that Congress either create one or more self-regulatory organizations ("SROs") to oversee registered investment advisers, allocate the job to the Financial Industry Regulatory Authority ("FINRA") or impose user fees on the industry to pay for their oversight by the SEC's Office of Compliance Inspections and Examinations.

As expected, the report found that the SEC does not have sufficient resources to oversee the 11,000 currently-registered investment advisers. In July, however, this number will be closer to 7,500 when Section 410 of Dodd-Frank is implemented and advisers with \$100 million or less assets under

management are required to register with the state where their principal place of business is located. Even with this decrease, the SEC still does not expect to be able to oversee all the registered advisers because the industry is expected to grow such that the decrease will be offset. We expect this oversight debate to play out in Congress in the coming year, with the investment adviser community strongly favoring supervision by the SEC, rather than a more powerful SRO or FINRA.

SEC STAFF RECOMMENDS FIDUCIARY DUTY FOR BROKERS RULEMAKING LIKELY TO FOLLOW

On Friday, SEC staff recommended that the agency create tougher rules for how brokers sell investments to clients, by creating a fiduciary duty for more than 600,000 registered brokers and millions of their customers. The suggestion comes from a study mandated by Dodd-Frank. Originally, when Dodd-Frank language was being debated, the House would have required the SEC to implement a fiduciary duty for brokers, rather than merely conduct a study. When in conference with Senate legislators, however, an amendment was agreed upon to reduce the mandate to a study, and thus the results of the SEC's report are not surprising. The SEC will likely initiate a rulemaking to create the duty, which among other things will make it much easier for clients to sue brokers when an investment fails. Opponents of the idea noted that a rule of this nature could lead to increased investing costs, fewer products on the market, and a flood of litigation.

MIXED MESSAGES ON REGULATION FROM THE OBAMA ADMINISTRATION

On Jan. 18, President Obama signed an [Executive Order](#) and two memoranda to regulatory agencies intended to make current regulations less burdensome, and to eliminate outdated or overly costly regulations currently on the books. Senior officials said the order requires agencies to design cost-effective, evidence-based regulations to promote economic growth, job creation and competitiveness.

The order establishes practices that ask agencies to reduce the costs and burdens to businesses and the public and expand opportunity for public input. This may come as some relief to those in the banking industry who feared increased regulatory burdens. Agencies will be looking at all existing rules and identifying those to be eliminated or modified. Some view the Executive Order as ironic, given the cost and time that will be devoted to such laws as Dodd-Frank.

BANKS OF ALL SIZES MAY BE SUBJECT TO BASEL III CAPITAL STANDARDS

On January 19, Acting Comptroller of the Currency John Walsh said that US regulators are considering a wider application of Basel III capital standards beyond the large and internationally active banks that are the focus of the standards. Walsh said it is not too early for banks of all sizes to begin preparing for potential changes that may arise from new Basel and Dodd-Frank frameworks. He emphasized that no decisions have been made concerning a broad US application of the Basel III measures.

Walsh said scope also applies to the new liquidity standards; during the financial crisis many banks experienced a cash crunch and there was a widespread reliance on the Fed for liquidity. The Basel standard would limit overreliance on short-term wholesale funding and encouraging a more thorough assessment of liquidity risk. Although Dodd-Frank does not require US banks to be subject to Basel III, regulators must decide how to apply formal liquidity standards to banks.

GAO STUDY FINDS NO NEW REGULATION FOR FINANCIAL PLANNERS NEEDED

In a [report](#) released January 18, the Government Accountability Office found that the regulatory structure applicable to financial planners “covers the great majority of their services,” but there are shortfalls in enforcement and in consumer protection. Despite this, the GAO did not find need of additional regulations specific to financial planners. The spotty enforcement of existing regulations has caused three consumer protection issues: 1) consumers may be unclear about when a financial planner is required to serve the client's best interest 2) consumers may be unable to distinguish among the titles and designations of financial planners and 3) the extent of the enforcement problems are unknown because the SEC does not track that information.

The report asserted that the current regulatory system should have data to identify risks and problem areas. GAO also noted that several different approaches have been offered for regulating financial planners:

- Creation of a federally chartered board that oversees financial planners;
- Augmenting oversight of investment advisers with a self-regulatory organization;
- Extending the fiduciary standard of care to more financial services professionals; and
- Specifying standards for financial planners and the designations they use.

However, most regulators and representatives of the financial services do not favor significant changes to the current regulations, and suggested instead:

- NAIC assess consumers' understanding of the standards of care associated with the sale of insurance products;
- SEC assess investors' understanding of financial planners' titles and designations; and
- SEC collaborate with the states to identify methods to better understand problems associated with investment advisers' financial planning activities.

SEC INQUIRY SUGGESTS GREATER INVESTIGATION INTO FCPA VIOLATIONS

Recently, the SEC sent inquiry letters to certain financial institutions over possible Foreign Corrupt Practices Act (FCPA) issues related to their dealings with sovereign wealth funds. Some insiders believe that this is a harbinger of wider investigations in the industry, and that banks should take this as a warning to review and revise their compliance programs.

In the letters, the SEC asks broad questions about the institutions' relationships and interactions with wealth funds and their FCPA compliance programs, indications that the SEC is still at a fact-gathering phase. Industry insiders believe that the DOJ and the SEC will likely be working together to bring parallel enforcement actions. Some suggested means of mitigating risk include:

- ensuring that managers at subsidiaries and branches are experienced in FCPA compliance;
- instituting strong accounting controls and periodic FCPA audits;
- training employees in compliance issues;
- instituting accurate record keeping; and
- setting clear policies for gifts and entertainment and for facilitating payments.

FSOC REQUESTS COMMENT ON NEW M&A RESTRICTIONS

The Financial Stability Oversight Council asked for comment within 30 days of January 18th on a [study and set of recommendations](#) intended to mitigate risk in the financial sector by putting new restrictions on mergers and acquisitions by large financial institutions. Generally speaking, Section 622 of Dodd-Frank bars financial firms from acquiring or merging with another company if the resulting company's consolidated liabilities would exceed 10 percent of the aggregate consolidated liabilities of all financial companies.

According to the report, new limits will lead to more competitive markets “by preventing the increased dominance of those markets by a very small number of firms.” However, FSOC staffers said that other effects, including advantages to foreign firms, are also possible. Foreign companies would be at an advantage because Section 622 only considers liabilities of foreign firms’ U.S. operations whereas U.S. firms’ are based on global liabilities. The Fed will have nine months to craft regulations to implement FSOC’s recommendations.

GOLDMAN EXEC NAMED AS NEW DIRECTOR OF SEC DIVISION

The SEC announced earlier this week that Goldman Sachs executive Eileen Rominger has been named as head of the agency’s Division of Investment Management. Rominger will start her new position next month, and is replacing Andrew J. Donohue, who left the SEC in November. Prior to this appointment, Rominger was Goldman’s global chief investment officer, and also spent 18 years at Oppenheimer Capital. The Investment Company Institute stated its delight at the appointment, noting that Rominger is a “seasoned investment professional... [with] unique credentials... her qualifications will very effectively serve the interests of America’s mutual fund investors and the mission of the SEC more broadly.”

U.S. PUBLIC PENSIONS IN ECONOMIC TROUBLE

According to Orin Kramer, former chairman of New Jersey’s pension fund, U.S. public pensions face a shortfall of \$2,500 billion. This could force state and local governments to sell assets and make deep service cuts. Cost pressures from retirement benefits and Medicaid have increased asset sales and privatization and diminished the availability of safety nets for vulnerable citizens.

The Pew Center on States estimates that the funding gap for pension, healthcare, and other benefits was at least \$1,000 billion at the end of FY2008. Pension liabilities are not included in state and local government debt figures. Concerns about the financial health of local governments have sparked warnings of a rise in defaults for cities and towns and a sell-off in the \$3,000 billion municipal bond market where they raise money.

MSRB REQUESTING COMMENT ON PAY-TO-PLAY DRAFT PROPOSAL

Earlier this week, the Municipal Securities Rulemaking Board (MSRB) announced that it is requesting comments on a [draft proposal](#) to curb municipal advisor pay-to-play activities. Pay-to-play refers to municipal advisors who seek to obtain business from state and local governments, public pension plans and other municipal entities through making or soliciting contributions to government officials. The proposal would bar municipal advisers who make certain political contributions from practicing their advisory services with municipal entities for compensation for a period of two years. The rule would also

bar advisors from soliciting third-party business from a municipal entity for two years, would create an exception for municipal advisors who make a de minimis political contribution of up to \$250..

The Dodd-Frank Act extended the MSRB's responsibilities to municipal advisors. The MSRB already has a similar rule for municipal securities dealers. MSRB Executive Director Lynnette Kelly Hotchkiss said, "Our proposed rule seeks to sever any connection between political contributions to municipal government officials and the awarding of advisory service business to municipal advisers."

UPCOMING HEARINGS

On Wednesday, January 26th at 9:30am, in HVC-210 Capitol Building, the House Oversight and Government Reform Committee will be holding a hearing entitled "Bailouts and the Foreclosure Crisis: Report of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP).

On Wednesday, January 26th at 10am, in 2128 Rayburn, the House Financial Services Committee will hold a hearing entitled "Promoting Economic Recovery and Job Creation: the Road Forward."

On Wednesday, January 26th at 2pm, in 2175 Rayburn, the House Education and the Workforce Committee will hold a hearing entitled "State of the American Workforce."