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FINANCIAL SERVICES LEGISLATIVE AND REGULATORY UPDATE

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Leading the Past Week

This past week saw the release of two major, much awaited, and significantly lobbied components of the implementation of the Dodd-Frank Act. However, the announcement of the notice and comment period for both the so-called Volcker Rule and how the FSOC will determine "systemically important financial institutions (SIFIs) will only result in increased pressure on the administration and congress. The FDIC jointly released the Volcker Rule, which would ban proprietary trading, and limit a banks access to a variety of funds, though interestingly the CFTC did not formally release its version of the rule. Similarly, the FSOC released a plan to designate firms as SIFIs, leaving several aspects of the proposal open ended to accommodate for further public comment and pushback from firms that would be designated systemically significant. The backlash to Bank of America's and other bank's debit card fee announcement continued with lawmakers introducing multiple pieces of legislation to combat the fees. Finally, on Friday we saw a flurry of recommendations to the Supercommittee as the October 14th deadline for recommendations from the authorizing committee tolled.

Supercommittee Update:

As noted above, the October 14th deadline for the authorizing committee recommendation came and went on Friday and a variety of committees, members and minority components of the committee passed along their suggestions. With that milestone passed, there is going to be a rush to get pen to paper to draft legislative language for these concepts since even though the official deadline for the Supercommittee to get its recommendations to the full Congress is November 23rd, as has been widely quoted, CBO Director Douglass Elmendorf has indicated that in order for CBO to score the report it needs to be received by early November.

While Democrats and Republicans on the Committee both seem to be supportive of tacking corporate tax reform, questions arise over how to pay for a rate reduction. Supporters of corporate rate reductions argue that a lower rate will spur innovation and economic growth while dissenters push for revenue raisers to offset lower rates. Despite a growing appearance of common ground on some type of corporate overhaul, Supercommittee members will still face several hurdles. Economists have warned that cuts to certain corporate tax incentives—such as R&D credits and domestic manufacturing deductions—could harm industry more than a rate reduction would help. Additionally, it is unlikely that Democrats will be content with a plan that does not involve some sort of revenue increase.

With the negotiations over what to cut within the Supercommittee ongoing, lawmakers who do not sit on the body charged with deficit reduction are taking every opportunity to lobby their peers. Whether members of the Supercommittee appreciate their colleagues' guidance or not is unknown as the Committee remains just as tight-lipped with their peers as they do with to press and the public. Senator Carl Levin (D-MI) said Committee members "simply will not give us their reaction either privately or publically." Moreover, it appears some members have begun to chaff against the Supercommittee. On October 13th, Representative Maxine Waters (D-CA), introduced legislation to repeal the Supercommittee's statutory authority to make budget cuts. Waters said the Committee should be "promptly dismantled so that regular order can be restored and the federal government can fully dedicate itself to creating jobs and stimulating the economy." Waters' legislation is unlikely to succeed; however, it does reflect fear that the Supercommittee will harm members' interests. Though there is a growing consensus that the Supercommittee will not meet its target it will be forced to include in its recommendations a "requirement" that Congress take up action in 2013, for example of tax reform, that will be required to reach a certain dollar figure in savings so as to avoid sequestration.

Legislative Branch

Senate

GOP Introduces Legislation to Extend Derivatives Rulemaking Deadline: On October 4th, Senator Mike Crapo (R-ID) introduced legislation to extend the deadline for derivatives rulemaking. The measure currently has six cosponsors, none of which are Democrats. The Dodd Frank Improvement Act (S. 1650), in addition to extending the derivatives deadline to July 16, 2012—established an Office of Derivatives within the SEC to monitor swaps markets and finalize swaps rules. The bill also: directs the SEC, CFTC and other regulators to create a coordinated timeline for implementation of final derivatives rules; grants the SEC and CFTC with exemptive authority to oversee rules implementation; exempts end-users from margin requirements; redefines 'major swap participant;' and directs the SEC and CFTC to give greater consideration to international swaps markets.

Free Trade Agreements Look to Boost American Exports: On October 12th Congress passed three free trade agreements with South Korea, Colombia, and Panama. The U.S. International Trade Commission expects the deals to spur billions of dollars in increased exports once fully in effect. The deal with South Korea alone is estimated to create $10.9 billion in new exports as it removes two-thirds of duties on farm exports and 95 percent of consumer and industrial tariffs. Eliminated regulations will permit direct investment of U.S. corporations in foreign firms and could provide another boost for the nine-nation Pacific Partnership Trade Accord.

House of Representatives

Members Respond to Bank of America Fee Announcement: On October 12th, Representatives Jason Chaffetz (R-UT) and Bill Owens (R-NY) introduced the Consumer Debit Card Protection Act (H.R. 3156) to repeal the so-called Durbin amendment to the Dodd-Frank Act which required the Federal Reserve to see a debit interchange fee. The Chaffetz-Owens bill is one of several in response to the announcement that Bank of America would be rolling out fees for debit users. Other Congressional responses to the debit fees include Representative Brad Miller's (D-NC) legislation to waive fees for those customers who wish to switch banks.

Meanwhile, Representative Peter Welch (D-VT) is leading a letter calling on Attorney General Eric Holder to investigate possible antitrust violations in banks' new debit fees. Welch is joined by some of the most liberal members of the Democratic Caucus, including Representatives John Conyers (D-MI), Michael Honda (D-CA), Raul Grijalva (D-AZ) and Keith Ellison (DFL-MN). The letter warns that the "collective pricing activity is harmful to competition, raises serious legal questions, and has led to consumers and merchants in the United States earning the dubious honor of paying the highest credit card swipe fees in the world" and that "communications between banks and bank associations that may amount to price signaling or collusion have occurred in the wake of congressional action to reform debit card swipe fees."

Not surprisingly, the Welch letter has already solicited numerous responses from the banking industry and merchant's groups. Electronic Payments Coalition spokesman Trish Wexler said that the fees should not come as a shock to lawmakers who were warned by consumer advocates, economists and regulators that "the Durbin amendment would harm consumers." Conversely, merchant's groups responded in support of Welch's letter. The Merchants Payments Coalition released a statement urging the Department of Justice "to investigate and, if warranted, send a clear message that banks can't coordinate fee increases with their competitors." The real question remains whether the Obama Administration, which has clearly decided that beating up Wall Street plays well with their base, will pay any heed to the Welch letter's allegations.

House Agriculture Committee Debates Changes to Dodd-Frank Act: On October 12th, the House Agriculture Committee had hearing to consider various legislative proposals to amend the Dodd-Frank Act. The four bills the Committee considered were: H.R. 1840, which would require the CFTC to assess the costs and benefits of its actions; H.R. 2682, the Business Risk Mitigation and Stabilization Act, to ensure that end users can continue to use derivatives to manage business risks; H.R. 2779, which clarifies that inter-affiliate transactions are not to be regulated as swaps; and H.R. 2586, the Swap Execution Facility (SEF) Clarification Act, which prohibits the regulators from requiring a minimum number of participants to receive or respond to quote requests.

Executive Branch

FDIC

FDIC Approves Volcker Rule for Public Comment: On October 11th, the FDIC released their much anticipated Volcker Rule proposal, which clocked in at just fewer than 300 pages. Generally, the proposed rule precludes—with some exemptions—banking institutions from conducting proprietary trading and requires banks to limit investment in hedge funds and private equity funds. The proposal is open to public comment ending January 13, 2012. Acting FDIC Chairman Martin Gruenberg said the 90 day comment period will provide "ample opportunity" for stakeholders to weigh and accommodate for the significant opposition to the rule. The CFTC is soon expected to issue a "comparable" proposal, though the fact that it didn't issue a contemporaneous rule raised eyebrows and only further served to fuel rumors that Chairman Genseler is attempting to expand his turfdom.

In a memo released with the proposed rule, the FDIC provided insight on the proposed rule, with staff indicating that the proposed definition of proprietary trading "parallels" the statutory definition and the "covered financial positions" include: securities, derivatives, commodity futures and options. The rule also exempts certain functions and provides room for regulators to allow activities if they further "the safety and soundness of banking entities and the financial stability of the United States." Currently, the rule includes three exemptions : 1) market- making and underwriting activities; 2) risk mitigating hedging; and 3) "trading in certain government obligations, trading on behalf of customers, trading by a regulated insurance company, and trading by certain foreign banking entities," although there remains much uncertainty surrounding how these exemptions will ultimately work.

Immediately following the FDIC's release criticism from both the right and the left began to come in with both sides appearing to raise concerns that the rule was overly complicated and left many questions up in the air. For example, the American Bankers Association, charged that the "oversized nature" of the rule "will make it unworkable." While Americans for Financial Reform, called for "major improvements" to the rule, saying that the "vagueness of the rule, and the hundreds of questions it includes, underline the fact that regulators are still in the midst of crafting a final product."

Although the SEC approved the Volcker Rule unanimously the following day, Commissioner Troy Paredes also expressed concerns and said he is only supporting the rule so as to gather public feedback. Paredes posited that the rule could curtail market making ability, impact US competitiveness and impose burdensome compliance costs. Additionally, the House Financial Services Committee announced that they will hold a hearing on the proposal sometime in mid-November.

Financial Stability Oversight Council ("FSOC")

FSOC Releases Criteria for Evaluating Systemically Significant Firms: On October 11th, the FSOC voted on criteria to evaluate what firms should be systemically important financial institutions (SIFIs). The proposal outlines a three stage process to identify nonbank financial firms with assets over $50 billion as SIFIs. The three stage process will: 1) use specific quantitative thresholds to identify companies for additional scrutiny; 2) analysis of qualitative factors such as consultations with regulators; and 3) final FSOC designation. The first stage is meant to remove most firms based on a two part profile and asset test to identify if a firm has: over $30 billion in credit default swaps; over $3.5 billion in derivatives liabilities; over $20 billion of outstanding loans borrowed or bonds issued; or a 15-to-1 or greater leverage ratio.

The proposal is FSOC's second bite at the apple, revisiting a January proposal which was criticized for vagueness. However, in the new proposal, some criteria remain purposefully vague, with several provisions identified for further consideration. One area flagged for additional work—and where the FSOC will perhaps seek additional comment— is the role of asset managers.

CFPB

CFPB Identifies Concerns with Mortgage Lending as Priority: In a speech before the Mortgage Bankers Association on October 11th, Raj Date, Special Adviser to the Secretary of the Treasury for the CFPB, pointed out three large flaws in the mortgage lending system: transparency, incentives and fair competition. To that end, Date called for greater transparency so borrowers may understand complex loans, realigned incentives that consider the long-term performance of the loans and leveling the playing field by subjecting all lenders to the same rules.

In a statement by the CFPB on October 13th, Date said mortgage lending is a "priority" for the CFPB because of the "huge impact" of mortgage servicing on consumers and that 300 examiners and field managers will be undertaking a "close and measured look" at mortgage lenders. The examination will begin with loans in default to ensure transparency in foreclosures and potential loan workouts. The Bureau will also examine banks' internal processes for referring loans for foreclosure to ensure records are properly reviewed and the appropriate fees are levied.

The mortgage servicing examination plan was released as part of a more expansive CFPB Supervision and Examination Manual providing guidance in supervision of depository institutions and nonbank financial services institutions. The CFPB will begin examination efforts will year-round supervision of banks with assets of more than $100 billion. Exempt from these examinations are nonbank financial firms—which cannot be examined until a confirmed Director is in place.

CFTC

CFTC to Consider Position Limits and Derivatives Clearing Rules: On October 11th, the CFTC confirmed that the October 18th Commission meeting will focus on final derivatives clearing organization rules and on position limits for futures and swaps. The release announcing the meeting said that the derivatives clearing organization rule will address "general provisions" and core principals. In addition to considering the two rules the Commission will consider a Notice of Proposed Amendment on the effective date of swaps regulation. In remarks before the Futures Industry Association, Chairman Gary Gensler shed light on other CFTC rules are nearing completion, including rules related to external business conduct standards, foreign trade boards and swap data reporting, Gensler also noted several rules that are in the "queue" for consideration, including: designated contract markets, internal business conduct rules, real time reporting, cleared swaps and a swaps end-user exemption.

SEC

SEC Releases Guidelines on Cybersecurity Disclosures: On October 13th, the SEC Division of Corporation Finance released guidance on companies' disclosure obligations in the event of a cybersecurity breach or other incident. The guidance asks publically traded firms to consider the impact of a cyber attack when creating balance and income statements and risk assessments that are filed quarterly with the SEC. The guidelines also detail how cyber risks should be weighed and what reporting must occur following a cyber breach—in the event of a "material" attack, companies should be prepared to disclose losses and "potential costs and other consequences."

Treasury

2011 Budget Deficit is Second-Highest on Record: The Treasury Department announced on October 14th that the United States had a $1.29 trillion deficit for fiscal year 2011. Exceeding last year by $4 billion, it is second only to the record set in 2009. The $1.41 trillion deficit of that year was due in large part to the bailout of the financial markets and stimulus package. While the announcement may embolden deficit hawks, the deficit shrank (-0.3%) as a percentage of GDP from 2010. That trend is likely to continue with the discretionary spending cuts made in this summer's Budget Control Act, cuts made by the Supercommittee or sequestration.

<u>International</u>

Geithner Attends Paris G-20 Meeting to Urge Resolution of Sovereign Debt Crisis: On October 12th, the Treasury Department's Undersecretary for International Affairs Lael Brainard said that US regulators will be increasing their pressure on European leaders to address their sovereign debt crisis. At the moment, EU leaders are targeting October 23rd to meet to agree on a plan to address the debt crisis. Brainard said that despite having the resources to deal with the crisis, leaders are delaying and the "consequences of delay are growing." To that end, Secretary Geithner attended a meeting of G-20 finance ministers and central bank governors to discuss the debt situation. Following the meeting, Geithner said he heard "encouraging things from our European colleagues in Paris about a new comprehensive plan to deal with the crisis on the continent." Nevertheless, Geithner warned that there is "more work to do on the strategy and the details."

UPCOMING HEARINGS

The House will be in recess this week

On Tuesday, October 18th at 10am, in 428-A Russell, the Senate Small Business and Entrepreneurship Committee will hold a hearing titled "The Small Business Jobs Act of 2010, One Year Later."

On Tuesday, October 18th at 10am, in 215 Dirksen, the Senate Finance Committee will hold a hearing on options for overhauling the tax system focusing on incentives for charitable giving.

On Wednesday, October 19th at 9:30am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance, and Investment will hold a hearing titled "Market Microstructure: Examination of Exchange-Traded Funds (ETFs)."

On Thursday, October 20th at 10am, the Senate Banking Committee will hold a hearing entitled "Housing Finance Reform: Continuation of the 30-year Fixed-rate Mortgage."

On Thursday, October 20th at 2pm, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Subcommittee on Security and International Trade and Finance will hold a hearing titled "The G20 and Global Economic and Financial Risks."