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FINANCIAL SERVICES LEGISLATIVE AND REGULATORY UPDATE

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Leading the Past Week

Two major events bookended this past week, which although not connected, provide a prism to view Congress and Washington, DC through in 2012. The beginning of the week saw the release of the President's FY 2013 Budget, which Republicans labeled DOA and purely a political document. However, those proclamations didn't prevent officials from across the Administration to go before Congress to justify their agencies' budget and defend the proposal. Treasury Secretary Geithner appeared to be everywhere this week, appearing before three Committees, and clearly irritating House Republicans with his "silly little smirk." Other Administration officials, including CFPB Director Richard Cordray appeared before Congress. The day after the budget was released, we saw the extended deadline for public comment on the Volcker Rule toll, and throughout the week, all sides of this contentious debate began publicizing their comments. Other implementations of Dodd-Frank continued as the CFTC finally set a date for a long-delayed vote on the definition of swaps related entities and the CFPB announced, through the larger participation rule; it would be targeting debt collectors and credit reporting companies under its nonbank supervision program. Then the close of the week saw both parties in Congress come together to work out a deal to pass a year-long extension of the Unemployment Insurance / Doc Fix / Payroll tax bill. This may be the last major piece of legislation to be enacted until after the elections in November, but it shows that it is possible for Congress to move pass the political rhetoric to get things done.

President Obama Finally Releases his FY2013 Budget:

Last Monday, the President released his FY 2013 budget request and then dispatched his agency heads to make the rounds on the Hill during the week to support / defend this proposal. While the $3.8 trillion spending proposal outlines $4 trillion in deficit reduction cuts over the next ten years, the budget also increases allocations for agencies responsible for implementing and enforcing the Dodd-Frank Act. However, it is widely acknowledged that many, if not all of these increased budget requests are unlikely to be granted by Congress.

SEC: Under the President's budget there is a request for $1.57 billion to fund the SEC, an 18.55 percent increase from last year. In a statement on the Budget, Chairman Mary Schapiro said the increase would allow the Commission to strengthen enforcement and confidence in the markets. The budget increase would enable the agency to hire 626 new staff members (15 percent more than currently), especially bolstering staffing in the Office of Compliance Inspections and Examinations, the Enforcement Division and the Division of Corporation Finance. The SEC will also use its $50 million reserve fund, funded by transaction fees authorized by Dodd-Frank, to improve its website, the consolidated audit trail (CAT) and the Electronic Data-Gathering, Analysis, and Retrieval (EDGAR) system. Finally, the SEC said it would use the funding to expand the Division of Investment Management to accommodate new responsibilities related to mutual funds and exchange traded funds.

CFTC: Under the FY 2013 budget request the CFTC would receive $308 million, $1 million less than the FY2012 request but 33 percent more than the $205 million ultimately provided by Congress. Under the proposal, $145 million of the budget allocation would go toward paying existing staff and increasing staffing to meet the demands of regulating the large swaps marketplace and its responsibilities under Dodd-Frank. The White House calls these staffing increases critical "to carry out both the CFTC's current authorities, as well as its new regulatory responsibilities." However, Commission Scott O'Malia pushed back on the need for additional staff calling the move "unrealistic and unsustainable in this deficit environment." As further justification for the need for increased funding and staff, the White House released data on trends in the futures and derivatives market which show the commodity futures such as interest rates, currencies, Treasury bonds and securities now account for the majority of trading.

The CFTC budget proposal includes a plan to fully fund the agency through user fees which would need to be authorized by Congress. Currently, the SEC uses these fees to offset its own funding and has repeatedly made the argument that, because of the offsets, they should be given authority to set their own budget. No matter the fate of the user fee proposals in the budget, it is unlikely that Congress will fund the agencies at the amounts requested.

Also included in the Budget were some controversial provisions of interest to the financial services industry, including another run at the bank tax (unlikely to be enacted) and also proposed modifications to the tax treatment of incentives to encourage retirement savings.

Legislative Branch

Senate

Senate Committee holds European Debt Crisis Hearing:

February 16th the Senate Banking Committee held a hearing on the threat of the European debt crisis to the U.S. economic recovery. US officials underscored the need for Europe to tackle the debt crisis head on, lest it spread to damage the world economy. Lael Brainard, the Undersecretary for International Affairs at the Treasury Department, noted that while a worsening of the situation could harm the United States, that the there are only "modest" risks to the American banking system due to the creation of "thicker capital cushions and better liquidity buffers" following the 2009 financial crisis. She also stressed that Europe has the capacity to deal with the crisis. Even so, Steven Kamin, Director of the Division of International Finance at the Federal Reserve, remarked that troubles in Europe are "restraining our exports, weighing on business and consumer confidence, and adding to pressures on U.S. financial markets and institutions."

Senate Banking Examines Executive Pay:
The Senate Banking Subcommittee on Financial Institutions and Consumer Protection held its latest hearing in a series titled "Banking that Benefits Main Street," on February 16th. The hearing focused on whether executive compensation at too-big-to-fail financial institutions played a role in the financial crisis. Subcommittee Chairman Sherrod Brown (D-OH) noted that even as other Americans "struggl[ed] to stay in their homes or access credit for their small business, the brass on Wall Street saw record salaries, bonuses, and perks." Witnesses included the Deputy Inspector General for the Troubled Asset Relief Program, law professors from Harvard and Columbia, and a partner from the international law firm Winston & Strawn, LLP.

House of Representatives
Cordray Grilled on CFPB Budget:
On February 15th, the House Financial Services Subcommittee on Oversight and Investigations met to question CFPB Director Cordray on the CFPB's Budget. Currently, the CFPB may derive a maximum of 10 to 12 percent of the Fed's operating budget, with the option of requesting additional funds from Congress. While the Bureau is outside of the normal appropriations process, Republican Members argued that the CFPB's projected spending levels are significant enough to merit attention by Congress. Specifically, Chairman Randy Neugebauer (R-TX)—echoed by several of his colleagues—requested that the CFPB 'beef up' its spending plans to provide greater transparency and oversight.

While there was significant pushback from Republicans, Democrats defended the Bureau's funding scheme and spending levels for FY 2012 and FY 2013. Notably, Representative Barney Frank (D-MA) specified that a large portion of current CFPB spending is not new, but rather reflects the transferred legal authority and personnel from existing bank regulating agencies. Additionally, in response to criticism around the Bureau's spending plan, Representative Brad Miller (D-NC) reminded subcommittee members that the OCC—similarly structured and funded to the CFPB—supplies the same level of detail to Congress. Director Cordray also sought to reinforce the "considerable controls" on the Bureau's spending and operations, such as GAO and independent audits, and both its obligations under Administrative Procedures Act ("APA") process and its responsibility to convene small business panels – even though the Bureau's past precedents indicate sparingly use of both.

House Financial Services Advances Bills to Amend Financial Regulations:
The House Financial Services Committee advanced five bills on February 16th that would amend provisions of the Dodd-Frank Act and ease regulations for small businesses. H.R. 2308 the SEC

Regulatory Accountability Act was the most contested, but was passed out of committee following a 30 to 26 vote. The bill requires the Securities and Exchange Commission to explicitly state the problem to be solved by a rulemaking, to conduct a thorough cost-benefit analysis, and to explore alternatives to rules before they new ones can be issued.

H.R. 3606 the Reopening America Capital Markets to Emerging Growth Companies Act of 2011 was the only other bill to receive a roll call vote, and passed 54 to 1. It would amend the 1933 Securities Act and the 1934 Securities Exchange Act to create an exemption for emerging growth companies, those with less than $1 billion in annual revenue or up to $700 million in publicly traded shares, from various SEC reporting requirements for up to five years. As amended, the bill requires companies to file say-on-pay disclosures within a year of exiting the emerging growth category. H.R. 1838, a bill that would permit FDIC-insured institutions from engaging in certain securities swaps was passed via voice vote. It initially called for a complete repeal of Section 716 of Dodd-Frank, but a bipartisan amendment was adopted that would permit institutions to engage in equity, commodities, and certain credit default swaps; while continuing to preclude acidity related to subprime assets and asset-backed securities.

Two other bills, H.R. 3871 and H.R. 4014 were approved by voice vote, and would bind the Consumer Financial Protection Bureau to the same attorney-client confidentiality requirements ascribed to other government regulators that deal with proprietary information from financial institutions. H.R. 3871 achieves that by amending Dodd-Frank directly, while H.R. 4014 would amend the Federal Deposit Insurance Act. These bills have broad support from Democrats and Republicans and Director Cordray has said he sees the measure as a correction to an oversight of the Dodd-Frank Act. However, given Senate Banking Chairman Johnson's strong preference to avoid amending Dodd-Frank, it is more likely that H.R. 4014 will be the legislation to move.

House Judiciary Examines 'Overreach' in Recess Appointments:
On January 15th, the House Judiciary Committee oversight panel met to examine President Obama's January 4th recess appointments to the CFPB and National Labor Relations Board (NLRB). The hearing served primarily as a constitutional and legal analysis of the use of recess appointment procedures when the Senate was technically in *pro forma* session. Many members expressed concern over the growing dysfunction of the appointment process; however, members were generally split down party lines between the beliefs that the January 4th appointments were Executive overreach versus a necessary step to confront an 'obstructionist' Senate minority. In addition to a discussion of the legality of the January appointments, there was also discussion over how to address controversies surrounding the use of recess appointments. One solution to the recess appointment controversy, offered by Representative Franks, and supported by the witnesses, was to amend the Pay Act so that those appointed during a recess could be denied their salary by Congress.

<u>Executive Branch</u>
CFPB
CFPB Expands its Jurisdiction to Cover Debt Collectors and Consumer Reporting Firms:

On February 16th the CFPB announced that it will include large debt collectors and consumer reporting agencies under direct supervision by the Bureau through the larger participant rule. The Dodd-Frank Act requires the CFPB to supervise mortgage companies, payday lenders and private education lenders; however, leaves the CFPB discretion to identify other "larger participants" that merit increased supervision. Director Cordray told reporters that debt collectors and reporting agencies must be included in the Bureau's nonbank supervision because of the "critical role" they play in the marketplace. The rule allows the Bureau to routinely monitor large players in the industry: firms with more than $7 million in annual income from consumer reporting activities and debt collectors with more than $10 million annually would be subject to the rule.

Cordray emphasized that small entities in the debt collection and reporting industries also must comply with CFPB regulation and all other consumer laws. "Both smaller and larger entities will have to abide by any rules we adopt," said Cordray, "but the larger ones will have to allow us complete, unfettered access to their books and other information." Despite the impact on small entities, the manner in which the CFPB crafted the proposal, bringing only larger companies under their purview, eliminated the need to comply with their obligation under Dodd-Frank to assess the impact on small business before proposing a rule. Dodd Frank requires the larger participant rule be finalized no later than July 21, 2012. The proposed rule will be open for public comment for 60 days following publication in the Federal Register.

CFPB Releases Prototype Mortgage Statement Form:
Last week, the CFPB published a prototype mortgage statement to require lenders and servicers to share more detailed information about costs and features of borrowers' loans. The prototype includes monthly payment analysis to clarify how much money is put toward loan principal, interest and fees. Statements would also include information on housing counseling and loan servicer contact information for borrowers with financial difficulties. The prototype will be tested with both consumers and the industry who may provide further feedback prior to the CFPB releasing a proposed rule by the end of the year. In addition to the mortgage statement changes, the Bureau has announced two aspects of mortgage servicing on which it will focus regulatory efforts, including consumer protections for "force-placed insurance" and new consumer disclosures for hybrid adjustable-rate mortgages.

Treasury

Geithner Defends Budget Before Congress:
On three occasions last week, Treasury Secretary Geithner appeared before Congressional Committees to defend the President's FY 2013 Budget Request: the Senate Finance Committee on February 14th, the House Ways and Means Committee February 15th and the House Budget Committee February 16th. Before all three panels, Geithner characterized the Budget proposal as the correct balance between necessary spending, reduced outlays and revenue increases. Both Committees pushed back against the budget for its lack of vision for a balanced budget. However, Geithner warned lawmakers that stringent cuts now would hamper the current economic growth and jobs gains, saying that the President's $4 trillion, ten year deficit reduction plan is the appropriate path forward. Geithner also characterized the budget as a jobs proposal,

citing the infrastructure proposals as examples of how the budget is "good for jobs now" and "good for growth in the future."

Notably, Geithner said the Administration will soon release a framework for corporate tax reform. According to Geithner, the White House will release its principles for tax reform that will be a starting point for a debate about tax reform by the end of February. Geithner said he expects the proposal will find "a lot of common ground on broad elements" relating to tax reform. Based on his comments, it appears that this proposal will be focused on corporate reform only, and not include changes to the individual Internal Revenue Code.

White House

Budget Plan Includes Higher Taxes for Top Earners:

As part of his FY 2013 Budget proposal, President Obama is requesting taxation of dividends received by high-income individuals as ordinary income. The proposal would raise the top rate to 39.6 percent from 15 percent. The Budget proposal did not include the Buffet rule, supported by the President, which would impose a 30 percent minimum tax on those whose income is greater than $1 million a year. An overhaul to implement the Buffet rule and do away with the alternative minimum tax (AMT) would have to come as a separate rewrite of the tax code, said Gene Sperling.

Federal Reserve

Harsh Volcker Rule Comments Follow Closure of Comment Period:

February 13th was the final day to submit comments on the Volcker Rule to the Federal Reserve, FDIC OCC, SEC and Treasury—the five agencies responsible for jointly promulgating the rule. The closing of the comment period triggered a deluge of criticisms of the rule. Many of the comments reflected concerns with liquidity and competitive disadvantage, with the Institute of International Bankers predicting foreign banks will close US operations if the Volcker Rule goes forth as outlined. Additionally, Craig Donohue, CEO of CME Group, warned that the exemption for US Treasury debt was too weak to preserve the market of Treasury derivatives, futures and options trading. Similarly, Goldman Sachs warned that the rule could impact the US banks' ability to serve as primary dealers in sovereign debt.

Lawmakers also voiced concern with the Volcker Rule. Senators Tom Carper (D-DE), Mark Warner (D-VA), Chris Coons (D-DE), Pat Toomey (R-PA), Mike Crapo (R-ID) and Scott Brown (R-MA) sent a bipartisan letter to regulators cautioning about the possibility to Volcker Rule would limit liquidity and restrict market-making activities. Notably, the architects of the provision in the Dodd-Frank Act, Senators Carl Levin (D-MI) and Jeff Merkley (D-OR), were also critical of the proposed rule, though in the other direction, as they were asking regulators to be more forceful in their approach to the rule.

Former Federal Reserve Chairman Paul Volcker preemptively responded to critics in an op-ed in the Financial Times that ran on Monday last week. Volcker wrote that he was 'surprised' by the backlash the proprietary trading ban that bears his name has received. As evidence, he cited Europe's plans to introduce a financial transaction tax which "puts 'sand in the wheels' of overly liquid, speculation-prone securities markets" and a UK plan "to 'ring fence' trading and investment banking" with the same goal as the Volcker Rule. Volcker underscored that those who wish to engage in proprietary trades simply should not have access to the "taxpayer support implicit in the safety net of commercial banks" and urged us not to be swayed by the "smokescreen" of those dedicated to protecting the interests of risky banks.

Fed Approves Capital One Acquisition of ING Bank:
On February 14th, the Fed approved Capital One's request to acquire ING Direct. When finalized, the deal will make Capital One the fifth largest depository institution in the US with consolidated deposits of $210 billion. Despite the successful bid by Capital One, the acquisition faced numerous hurdles such as objections over mortgage lending and consumer credit practices at the banks. Thus, the Fed's approval order comes with several caveats including requiring new risk mitigation measures to address possible size and complexity concerns accompanying the deal. Still, the Fed's concerns over size were limited as it found that Capital One was not "highly interconnected" to many different channels of the US financial sector nor overly complex. The acquisition is the largest yet considered by the Fed under the new financial stability analysis required by the Dodd-Frank Act.

SEC
SEC to Revise Thresholds for Adviser Performance Fees:
On February 15th, the SEC announced that they are revising the thresholds that establish whether advisory clients can be charged performance fees. Section 418 of the Dodd-Frank Act mandated that the SEC adjust the dollar amount thresholds by July 21, 2011 (and then again every 5 years) to reflect changes in inflation. The new rule also includes several amendments that altered how calculations of net worth will be made going forward, including excluding the value of an individual's home from their net worth. In addition, the new rules will grandfather in the ability of advisers to undertake performance fee arrangements with "qualified clients."

Institutional Investors Urge SEC Stand Strong against Dodd-Frank Critics and Push Forward with Implementation:
As evidence that the entire financial services industry is not opposed to Dodd-Frank, on February 13th, fourteen public pension funds called on the SEC to push ahead with "unfinished business" over the next year. In a letter to Chairman Mary Schapiro, the funds requested that the SEC resist moves to "undercut the goals of" the Dodd-Frank reforms, warning that "if this movement is successful, there is the very real risk that investor confidence will erode." The institutional investors said they "stand ready" to come the SEC's aide in rebuffing efforts to weaken the financial reforms. The funds urged the SEC to take action on: a mandatory federal proxy access rule; appointing the Investor Advisory Committee; adopting executive compensation rules; creating International Financial Reporting Standards; increasing transparency and accountability in credit ratings; and promoting compliance with climate risk disclosures.

CFTC

CFTC Announces upcoming Vote on Derivatives Rules to take place on February 23rd:

On February 23rd, the CFTC intends to meet to vote on new rules as part of the Dodd-Frank implementation. At that time, the Commission is supposed to consider adopting rules to define swaps-related entities and related responsibilities for swaps dealers. In a statement announcing the meeting, the Commission said it may also propose a rule to set minimum block sizes for large notional off-facility swaps and block trades. However, since the three previous efforts by the CFTC to meet and vote on swap rules have been postponed, it would not be surprising if this meeting is delayed as well.

International

France Announces Intention to move Forward with Financial Transaction Tax:

In an interview February 13th, the French finance minister, François Baroin, said France will move forward with a financial transaction tax which is supported by many Eurozone countries. Baroin said the tax will be levied on share trades at one-tenth of a percent and is expected to raise €1 billion a year. The inspiration for the transaction tax was the UK's stamp duty which levied a .5 percent tax on shares, raising £2.7 billion between 2010 and 2011. Baroin explained that the tax has been carefully studied to ensure financial business in France is maintained while raising funds to pay down the aftermath of the financial crisis. While France may be prepared to go it alone with the tax beginning in August, it is expected many countries will follow suit.

World Bank President to Step Down:

Robert Zoellick, the current President of the World Bank, announced February 15th that he will not seek a second term when his first ends on June 30th. Generally, the president of the bank is an American, reflecting an informal agreement between the United States and Europe to split the leadership of the IMF and World Bank, however there could be a push from other countries to gain a leadership toehold. President Obama is expected announce a nominee in the coming weeks, with Secretary Hilary Clinton and Lawrence Summers as suspected candidates, though Secretary Clinton offered a vocal denial though a spokesperson.

UPCOMING HEARINGS

The House and Senate will be in recess this week.

On Tuesday, February 28th at 10am, in 2128 Rayburn, the House Financial Services Committee will mark up pending legislation regarding homeless children and FHA overhaul.

On Wednesday, February 29th at 10am, in 2128 Rayburn, the House Financial Services Committee will hold a hearing to receive the semi-annual monetary policy report from the Federal Reserve