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FINANCIAL SERVICES REGULATORY REFORM UPDATE

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With Congress in recess for a district work period this past week, it has allowed us to offer a greater focus on certain aspects of international financial regulation, and how those efforts may eventually be harmonized with the Dodd-Frank reforms.

With regulators on multiple continents attempting to institute financial regulatory reform, the line between harmonization and arbitrage is often a thin one. For example, some components of the financial services industry in Europe are asking its own regulators to slow down and consider the implications of their fast and furious (by European standards) rulemaking on the still-recovering economy. However, with the EU lagging considerably behind the US in terms of enacting broad scale reforms, the possibility for regulatory arbitrage is very real and appears to be a concern of both regulators and those in the industry. Therefore, it was not surprising that CFTC Chair Gary Gensler testified before the European Parliament this past week, and pled for an EU effort to reconcile the cross-Atlantic regulation of swaps markets, so as to avoid regulatory arbitrage to the detriment of U.S. firms and the U.S. economy. That said, there are areas where the Europeans appear to be ahead of the US, for example giving regulatory approval for the use of CoCo's for both compensation and capitalization. Additionally, the EU system is much more hospitable to the use of covered bonds, though the U.S. may also soon have its own covered bond market, if legislation by Reps. Garrett (R-NJ) and Maloney (D-NY) can make it out of Congress and onto the President's desk.

Congress returns this coming week for a busy schedule, though one dominated by the continued negotiations on the budget. Republican's appear to be attempting to tie a balanced budget amendment to the vote to raise the debt ceiling, which is likely to occur sometime during the next three weeks before Congress goes into another recess. Additionally, the middle of April marks another regulatory milestone for Dodd-Frank rulemaking and we should anticipate additional administrative actions over the coming weeks as agencies attempt to meet their Dodd-Frank deadlines for rulemaking.

EU INVESTORS ECHO U.S. CONCERNS OVER FINANCIAL REGULATION

Sounding eerily similar to the talking points used by the U.S. financial services industry and GOP lawmakers, some EU investors are now voicing their trepidation over the quantity, quality and rate of financial regulation taking place in Europe. Jean-Baptiste de Franssu, the president of the European Fund and Asset Management Association (EFAMA), which collectively manages $20 trillion in assets, stated unequivocally to the European commissioners and regulators this week, "you are going too fast, you are doing too much and the quality of what you are doing isn't up to the standards we have known in the past." De Franssu is particularly concerned with more than 25 EU and U.S. regulatory proposals that

could substantially impact the asset management industry, including those on taxation, derivatives and corporate governance. He reminded regulators that European asset managers are not "investment bankers trying to protect their bonuses," and highlighted the importance of his industry to the European economy. De Franssu expressed concern with EU regulations being much stricter than those in the U.S. and Asia, and suggested that instead the EU focus on bank supervision (rather than regulation). The EU's internal markets commissioner, Michel Barnier, on the other hand, has countered that the sense of urgency to implement regulatory reform is necessary, especially as the economy improves.

GENSLER ASKS EU TO WORK WITH U.S. ON SWAPS REGULATION

CFTC Chairman Gary Gensler spoke before the European Parliament's Committee for Economic and Monetary Affairs earlier this week, asking the EU to finalize its pending regulations and work to reconcile any differences between EU and U.S. laws. Gensler was essentially asking the EU to aid in its efforts to regulate the $600 trillion swaps market, which "will require a comprehensive, international response." Gensler went on to say that "with the significant majority of the worldwide swaps market located in the United States and Europe, the effectiveness of reform depends on our ability to cooperate and find general consensus on this much needed regulation." The European Parliament is set to vote on the issue in the coming months, and Gensler urged the legislative body to go further than what the European Commission has proposed, and include exchange-traded swaps in its regulations in order to make U.S. and EU laws "comparable." Without this reconciliation, U.S. banks may be restricted, as required by Dodd-Frank, from using EU-based clearinghouses.

EU POSSIBLY ALLOWING COCO BONDS TO MEET CAPITAL REQUIREMENTS FOR SIFIS

Earlier this month, the Basel Committee on Banking Supervision agreed in principle on criteria for identifying global systemically important financial institutions (SIFIs) and came close to agreeing on the maximum amount of additional capital these banks will be required to hold in order to offset their greater risk to the global economy. Once this agreement is finalized, the Financial Stability Board (FSB) will then have to sign off on the new regulations. The head of Switzerland's central bank stated earlier this week that he is confident that the FSB and Basel Committee will both recognize the use of contingent convertible (CoCo) bonds as counting towards SIFIs' additional capital requirements. The Swiss government put forward a proposal last December that would allow for up to 3% of an additional capital buffer to be comprised of CoCos, which led Credit Suisse to issue $2 million worth of the bonds in anticipation. As the issue plays out in the EU, it will be interesting to see what effect these negotiations and rules have on the Financial Stability Oversight Council's determination of its version of SIFI, known as "systemically significant non-bank financial institutions" in the U.S.

ANTITRUST CONCERNS ARISE IN NYSE EURONEXT/DEUTCHE BOURSE MERGER

In February, operators of the Frankfurt and New York Stock Exchanges (Deutsche Bourse and NYSE Euronext, respectively) agreed to a $25 billion merger, which would create a mammoth exchange with four times the revenue of the London Stock Exchange and take over 90% market share of European Union futures exchanges. Not surprisingly, European lawmakers are beginning to express antitrust concerns: EU competition commissioner Joaquin Almunía testified before a European Parliament hearing about his apprehension about the "vertical silo" model, in which an exchange would control both the trading and clearing of derivatives. Alumunia and the EU have promised a thorough review of the merger, lasting potentially more than a year, and this was the first indication that there might be some glitches. NASDAQ

has also indicated that it might attempt to purchase the NYSE, a move that also raised anti-trust concerns among US regulators.

Some industry players say that anti-competitive issues can be resolved rather simply, by a commitment to openness by the new entity. EU banks and interdealer brokers, on the other hand, are actively lobbying against silos because of the pricing power that a new mega-entity would impose. The U.S. has been much quieter on the issue because there are fewer antitrust apprehensions – there is substantially less overlap between the markets of NYSE Euronext and Deutsche Bourse here, though that analysis would change should NASDAQ successfully blow up the Deutsche Bourse bid.

NYSE Euronext also just announced the terms of its sale of the majority of its NYSE Amex options market to dealers such as Goldman Sachs, Citadel and Citigroup. The deal had been in the works since 2009, but the timing has the potential to preempt anti-competitive concerns that may be raised. 52.8% of the exchange will be sold off, with the electronic NYSE Arca market remaining as part of NYSE Euronext.

U.S. MOVES TOWARDS ADOPTING COVERED BONDS

Covered bonds, long a bastion of European investing practices, are finally making progress in the U.S., as two Representatives – Scott Garrett (R-NJ) and Carolyn Maloney (D-NY) – introduced the United States Covered Bond Act of 2011 early last week. The bipartisan bill would create a comprehensive legal framework of a U.S. market for covered bonds, which are technically already sanctioned by U.S. financial regulators but are seldom issued. Covered bonds are known for their relatively conservative nature (because lenders keep loans on their balance sheets as collateral), and as an alternative to much riskier MBS. Some financial services experts expect that this market could eventually account for 10-20% of total commercial and residential real estate lending. In the Senate, Senator Charles Schumer (D-NY) has expressed what can only be described as tentative support for Garrett's proposal, indicating that he would be examining the issue more closely, though it sounds like legislation is a ways off from being introduced.

While Congress considers whether to create a covered bond market in the U.S., EU fund managers are issuing warnings to investors about the misleading safety and lack of transparency in underlying loans to these products. While known as the safest form of bank debt – two centuries have gone by with no known defaults - the fund management group M&G Investments is cautioning investors that too few of the assets "let you see inside." One official at M&G stated that "even with the best structure in the world, if the underlying collateral is poor, there's not much benefit to being able to get your hands on it." These warnings come in the wake of two major offerings of covered bonds from Spain's BBVA and Banesto and Sweden's Swedbank.

DURBIN PREPARING FOR FILIBUSTER OF INTERCHANGE FEE DELAY

In a conference call with consumer groups earlier this week, Sen. Dick Durbin (D-IL) spoke about the furious lobbying effort by the banking and credit card industries (who are "dramatically outspending our efforts") in order to stop or at least delay new limits on the debit card "swipe fees" charged by banks. Rep. Shelley Moore Capito (R-WV) and Sen. John Tester (D-MT) have both introduced legislation that would require a study of the fee issue and delay implementation of the rule for one or two years, respectively. Durbin promised his supporters on the call that any Senate effort to put off the new fee limits would need to garner 60 votes in order to move forward, and it is not apparent that supporters of

Tester/Corker have enough support to surmount this threshold. The Fed rule is expected to be finalized on April 21st, and will be effective as of July 21st, but it is unclear how Congressional efforts, such as the hearing in the House Financial Services committee on the Capito/Wasserman-Schultz bill will impact that rulemaking process. For example, the Fed could decide to defer its rulemaking if it appears that Congress is actively considering revising the rule.

In the meantime, Chairman Bernanke announced that the Fed will be exercising "all the power [it] can" to guarantee that community banks will be exempt from the debit interchange fee cap. Bernanke has previously voiced concerns that the small bank carve-out would not work as intended, with market forces pressuring small institutions to set lower fees. Bernanke said the Fed is "quite aware that the Congress in writing this law intended for small issuers to be exempted." However, experts have indicated that regardless of Bernake's statements, the practical reality is that it may be nearly impossible to distinguish between classes of issuers in implementing the Durbin rule.

FASB TO CONSIDER RULES ON RELATIONSHIP LENDING BY U.S. BANKS

The Financial Accounting Standards Board (FASB) will be meeting in early April to reconsider proposed rules on initial measurement, or how loans and credit facilities are first recorded on a bank's books. The rules would potentially compel banks to clarify whether the transaction price of a loan differs from its fair market value, effectively requiring banks to disclose when they are giving clients a below-market loan in order to acquire future business. Supporters of the rule state that without this transparency, below-market lending is a purposeful mispricing of risk. Opponents, however, argue that this kind of lending is made in the ordinary course of business and banks should not be penalized as a result. Other opponents also assert that it would be logistically difficult to determine the market value of these loans because they are so infrequently sold. For now, it is still uncertain how FASB will rule on the issue of initial measurement.

TREASURY TO WIND DOWN ITS FANNIE- AND FREDDIE-BACKED MBS

On March 21, The Treasury Department announced its plans for winding down its portfolio of mortgage backed securities guaranteed by Fannie and Freddie. The Treasury will be selling bonds off at a rate of up to $10 billion per month to divest itself of the securities, earning between $15 and $20 billion over the course of the sales. The profits will not change the Treasury's policy toward "debt management objectives." The sales will start in March and will be subject to market conditions as they could lead to rising mortgage interest rates. Assistant Secretary for Financial Markets, Mary Miller said the Treasury "will exit this investment at a gradual and orderly pace to maximize the recovery of taxpayer dollars and help protect the process of repair of the housing finance market." Treasury's actions are not anticipated to impact either the bond market or the mortgage market since its holdings represent a fraction of each. Additionally, Treasury's experience with winding down this portfolio could be instructive for the Fed, which controls a much larger amount of Fannie and Freddie backed MBS assets. Finally, despite the vehement and vociferous objections by Treasury, it is conceivable that these sales could move the date for a debt ceiling vote back by a few weeks, which would provide congressional and White House negotiators with more time to strike a deal on the FY11 budget, since it all but assumed that the two issues will be linked.

TREASURY MAY CONSIDER EXEMPTIONS FOR SOME FOREIGN EXCHANGE SWAPS

Rumors are circulating that the Treasury Department will soon be deciding whether to exempt some foreign exchange instruments from the Dodd-Frank Act derivatives rules. The Act leaves the fate of foreign exchange swaps to Treasury Secretary Geithner, who has been supportive of exemptions for these products, arguing that they do not pose significant risk to US markets.

While the exemption is backed by many banking groups and industry leaders, Better Markets Inc. outlined the argument against exemptions in a letter to Geithner last month. The letter argues that the Fed had to "bail out the foreign exchange markets with more than $2.9 trillion in October 2008… and with more than $5.4 trillion of foreign currency swaps following The Lehman Brothers bankruptcy."

TREASURY SPEAKS OUT AGAINST REPATRIATION TAX HOLIDAY

On March 24, the Treasury released a blog post coming out against a proposed tax holiday on overseas profits. A group of U.S.-based corporations, led by the Chamber of Commerce, have been pushing heavily for the repatriation tax holiday which would allow companies to bring profits back to the U.S. from overseas. Michael Mundaca, Assistant Treasury Secretary for Tax Policy said that the holiday could cost taxpayers billions of dollars, and asserted that instead the focus should remain on comprehensive tax reform. Mundaca cited the results of the tax holiday of 2004, saying: "there is no evidence that it increased U.S. investment or jobs, and it cost taxpayers billions…the nonpartisan Congressional Research Service reports that most of the largest beneficiaries of the holiday actually cut jobs in 2005 and 2006."

In response to Mundaca's statement, Chamber of Commerce COO and Executive Vice President David Chavern stated that he "presented a false choice," because "the real choice is not a tax holiday versus reform – it's do we want money returned to the U.S. economy or do we want it invested in competing economies overseas?" Despite the Chamber's response, it seems that congressional GOP leaders on the issue were warier of a tax holiday, as both House Ways and Means Committee Chairman Rep. Dave Camp (R-MI)) and the ranking member of the Senate Finance Committee (Sen. Orrin Hatch (R-UT)) stated via their staffers that they prefer to view the repatriation issue through a more comprehensive approach to rewriting the U.S. tax code.

SEC UNLIKELY TO ADDRESS FIDUCIARY STANDARDS BEFORE THIS SUMMER

Jennifer McHugh, a senior advisor to SEC Chairman Mary Schapiro, said that the earliest the SEC will be able to undertake rulemaking on uniform fiduciary definitions for investment advisors and broker-dealers is the summer as the agency has yet to designate a rulemaking team.

In January, SEC staff released a report advising that the SEC create a uniform fiduciary standard for all those who provide advice to customers, namely investment advisors and broker dealers. The staff study also called for a SEC assessment of whether current regulations for brokers and advisors should be harmonized. McHugh stressed that defining "personalized investment advice" is extremely important. Additionally, McHugh said that the Labor Department's proposal to expand the definition of fiduciary in ERISA, which is much further along in the rulemaking process, could raise some "practical issues" for the SEC.

EXPERT PANEL PROPOSES "TRADE-AT" RULE TO PREVENT FUTURE FLASH CRASHES

A panel of experts gathered to study and make recommendations in the wake of the May 6, 2010 "flash crash," including: Brooksley Born (former CFTC chair), Maureen O'Hara (chairman of the board of ITG), Joseph Stiglitz (Nobel Laureate and Columbia University economics professor) and others met last month to formulate a list of suggested fixes to market structures in order to avoid another crash. Most controversial of these recommendations is the "trade at" rule, which would require all off-exchange trades to improve the existing market price. The expert panel stated that this rule would incentivize traders to create more liquidity, and push more trading onto public exchanges. Industry associations such as the Securities Industry and Financial Markets Association (SIFMA) and Investment Company Institute (ICI) expressed strong opposition to the trade-at rule. On the other hand, many high-frequency traders have stated that they support more discussion of the idea, and public exchanges such as NYSE Euronext have also espoused the trade-at rule in the past. The SEC, in the meantime, has not yet stated whether a trade-at rule will be formally proposed.

SEC TO IMPLEMENT WHISTLEBLOWER RULES IN APRIL

SEC Enforcement Director Robert Khuzami spoke at a SIFMA seminar earlier this week, and stated that the Commission will be adopting rules to implement the whistleblower bounty program in April. The whistleblower program was proposed in November and will award those who come forward with "original information" concerning securities law violations will receive a percentage of monetary penalties that are greater than $1 million. Khuzami said the SEC "look[s] forward to implementing the whistleblower program in a way that factors in the important role of corporate compliance programs while providing whistleblowers a direct path to the SEC in appropriate circumstances."

The securities industry is concerned with the proposed rules, fearing that they will undermine corporate compliance programs. Khuzami stressed that Enforcement Division can now also pursue industry wide bars against professionals who violate SEC regulations or laws. The SEC will remain focused on pursuing wrongdoing on behalf of executives and board members.

HEDGE FUNDS AND PRIVATE EQUITY FIRMS EXPRESS CONCERN WITH SEC REGISTRATION TIMELINE AND DISCLOSURE REGULATIONS

On March 21, David Vaughan, an attorney fellow in the SEC's Division of Investment Management said that comments from hedge funds and private equity funds on proposed registration rules show that they want more time to register and are skeptical of the ability of the SEC to keep sensitive information confidential on registration forms. The comment period for the proposed rules on private funds registration ended in late January.

Firms are calling for a more flexible timeline for registration due to the burdens that the changing rules will impose. Firms are also deeply concerned with the amount of proprietary information they will be required to provide to the SEC such as business practices, fee arrangements, conflicts of interest and personnel. The rule would require firms to file forms with the SEC and the FSOC.

ISSA CHALLENGES SEC ON OVERREGULATION

Chairman of the House Committee on Oversight and Government Reform, Darrell Issa sent a 13-page letter to SEC Chair Mary Schapiro concerning the potential for financial overregulation. The letter asks for justification of several SEC rules related to raising capital and private equity. Issa said in the letter: "In this time of extraordinary high unemployment, no potential source of capital should be closed off to young, innovative companies" The letter poses 32 questions for Schapiro and requests a response with relevant documents by April 5.

SEC spokesman John Nester responded to Rep. Issa that "we agree with the need to review our securities offering rules and have been doing so consistent with our mission of investor protection, capital formation and fair and efficient markets." Beyond that remark, Nester refused to comment on Issa's letter before an official SEC response.

FDIC VICE CHAIR LIKELY SUCCESSOR TO SHEILA BAIR

Rumors have begun to circulate that Vice Chairman of the FDIC Martin Gruenberg is the likely choice to succeed Sheila Bair when she steps down at the end of her term. Gruenberg has been vice chairman since 2005 and served as acting chairman before Bair was appointed in 2006. Gruenberg is an expert in banking law and financial regulation and is a strong supporter of the Community Reinvestment Act. Mr. Gruenberg's nomination could be part of a larger White House push to fill high-level, empty banking-regulation posts such as at FHFA and OCC.

FEDERAL REGULATORS TO ADDRESS RISK RETENTION

At a FDIC board meeting on March 29, the agency will discuss the risk retention requirements for securitized mortgages. The Dodd-Frank Act set April 17 as the deadline for the finalized rule to be adopted by the FDIC; however, this will likely be pushed back so other regulators may approve the rule and leave time for public comment. The SEC also announced that it will be considering whether to propose rules on credit risk retention for securitizers of asset-backed securities at its March 30th open meeting.

Interagency disagreement has delayed finalization of the rule. In addition to the FDIC, the Fed, OCC, the National Credit Union Administration, the SEC, HUD and FHFA must all approve the risk retention rule. The regulators have reached a tentative agreement to require a 20 percent down payment for "qualified residential mortgages" which could be fully securitized. Loans that do not meet this standard would be subject to additional risk retention requirements. Despite compromise, FDIC chairman Bair expressed a desire for broader servicing standards and HUD Secretary Donovan called for a lower down payment requirement.

It is worth noting that the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises recently announced that it intends to hold a hearing on the risk retention rules at 2pm on Thursday, April 14th. Although it is possible that this hearing may be pushed back if the rule has not been finalized in time. If the hearing does take place on the 14th, our understanding is that it will be comprised of two panels, the first with each of the relevant federal regulators, and the second comprised of representatives of the different asset classes.

CFTC TO HOLD ITS 13TH DODD-FRANK RULEMAKING MEETING

On March 30, the CFTC will be holding a hearing to propose rules under the Dodd-Frank Act. This will be the 13th rulemaking meeting of the Commission with the purpose of deciding on rulemaking for data recordkeeping and reporting requirements for swaps undertaken before the Dodd-Frank Act was passed. The CFTC will also discuss various conforming amendments to ensure current rules meet with Dodd-Frank. Thus far the Commission has proposed 42 rules, all of which have yet to be finalized. CFTC Chairman Gary Gensler said the agency will finish proposing rules by the end of April 2011 and he has discussed finalizing them in stages.

CONGRESSIONAL "INSIDER TRADING" BILL INTRODUCED

Reps. Louise Slaughter (D-NY) and Tim Walz (D-MN) introduced the Stop Trading on Congressional Knowledge Act (STOCK Act) last week, which would prohibit federal employees and members of Congress from profiting from nonpublic information garnered through access to privileged, political-based information. Slaughter made a statement that the bill is intended to increase fairness and transparency, and create more oversight of the "growing 'political intelligence' industry." Federal securities laws already prohibit trading on material nonpublic corporate information, but there is no like ban for information gained in the course of government service. Other bills of this nature have been introduced since 2006, but none have moved forward in Congress.

UPCOMING HEARINGS

On Tuesday, March 29th at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing on public proposals for the future of the housing finance system.

On Wednesday, March 30th at 9:30am, in 2154 Rayburn, the House Oversight and Government Reform Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs will hold a hearing titled "Has Dodd-Frank Ended Too Big to Fail?"

On Wednesday, March 30th at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Oversight and Investigations will hold a hearing on the cost of implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (PL 111-203).

On Thursday, March 31st at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises will hold a hearing on pending legislation that would overhaul the operations of GSEs such as Fannie Mae and Freddie Mac.

On Tuesday, April 5th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises will hold a mark-up of pending legislation that would overhaul the operations of GSEs such as Fannie Mae and Freddie Mac (as discussed in the 3/31 hearing listed above).

On Wednesday, April 6th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on the Small Business Lending Fund, which was created by the Small Business Jobs Act of 2010 (PL 111-240). The $30 billion fund is intended

to encourage lending to small businesses by providing capital to qualified community banks with assets of less than $10 billion.

On Thursday, April 7th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Domestic Monetary Policy and Technology will hold a hearing on the U.S. Mint Bullion Program.