ML Strategies Update

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Financial Services Legislative and Regulatory Update

<u>Leading the Past Week</u>

On Friday evening President Obama formally notified the Office of Management and Budget to initiate the sequester, as both sides were unable, and more importantly unwilling, to reach an agreement on a plan to avert the automatic across-the-board spending cuts. Although the actual "D-Day" of the sequester initiates on March 1^{st}, the real impact (i.e., furloughs leading to delays in government services) will not begin to take effect in earnest until April 1^{st}. Ironically, it seems like both sides are in the same place with Democrats and Republicans counting on the American people to realize how the sequester impacts the role of government. Only, Democrats are hoping that people will realize they miss these services and Republicans are hoping that they won't. Because the real impact is not going to readily apparent until after the current funding for the federal government runs out, it seems like the next best chance for Congress to act on the issue will conflate with their need to keep the government operational after March 27^{th}, even if both sides are saying they want to keep the issues separate.

Against this backdrop of the sequester, Chairman Bernanke went to Congress to provide the Fed's semiannual monetary policy update where he defended the latest round of quantitative easing, provided an update on various Dodd-Frank rulemakings and cautioned against the potential market effects of the sequester. In other news, Jack Lew, who by some accounts was the person who thought about creating the sequester during negotiations on the debt ceiling agreement last August, was sworn in to be the 76^{th} Treasury of the Secretary.

Despite the looming threat of sequestration consuming much of the oxygen in Congress, this past week saw the Senate Banking Committee pledge to pass FHA reforms this Congress, and a flicker of hope that comprehensive tax reform is still alive.

Legislative Branch

Senate

Senate Confirms Jack Lew as Treasury Secretary

On Wednesday, Jack Lew was confirmed by a vote of 71 to 26 vote to be the next Treasury Secretary. The vote came quickly after the Senate Finance Committee approved his nomination 19 to 5 earlier in the week. Throughout the confirmation process Lew has signaled that he will be proactive as soon as he is confirmed, and indicated that carried interest, repealing subsidies for fossil fuels and reducing deductions for conservation easements would continue to remain on the chopping block under his watch during comprehensive tax reform. Lew was sworn in on February 28th and got to work quickly, chairing a closed meeting of the FSOC the same day. According to a press release the FSOC meeting featured a discussion of money market mutual fund reforms and the review of non-bank firms as systemically important.

SEC Chairman Confirmation Hearing Planned for mid-March

Last week the Senate Banking Committee indicated it hopes to hold a hearing on the nomination of Mary Jo White to be SEC Chairman on March 11th. In advance of the upcoming hearing, the White House has initiated its "charm offensive" on Capitol Hill. According to an article in the New York Times, White already supplied the Senate Banking Committee answers to a 20 page long questionnaire on her qualifications. However, in addition to these boilerplate questions, there continues to be some concerns express about Ms. White's turns in the "revolving door." In order to quell critics, she has apparently taken the unprecedented step of offering that, "as far as can be foreseen," she will return to her legal practice. Despite this, some members of the Committee remain skeptical about her ability to divorce her role as Chairman from her private clients, and how this will allow her to be an effective Chairwoman. While normally Republican's are the ones trying to knock down Obama appointees, in this instance, there may also be some friendly fire, as according to that New York Times article, Senator Sherrod Brown (D-OH) pushed White on that very issue.

Senate Agriculture Committee Holds CFTC Oversight Hearing

On February 27th, the Senate Agriculture Committee heard from CFTC Chairman Gary Gensler, who spoke about the agency's progress in implementing Wall Street reform and to share the CFTC's agenda for the coming year. During the hearing, the Committee also discussed the collapse of MF Global as well as the CFTC's efforts to protect customers and the integrity of the markets. At the hearing, it became evident that many lawmakers were concerned about the CFTC's swap execution facilities (SEF) rule. In response to a number of questions from lawmakers, Gensler said the upcoming SEF rule will be "technology neutral" and, while "a lot of progress" has been made on the rule, sequestration could impact how quickly firms will register with the CFTC as SEFs. **[for more on SEFs see our CFTC section below]**. Additionally, Chairman Gensler also touched on how the CFTC, in consultation with European regulators, will likely "take up" final rules for uncleared swaps and related capital rules in the second half of the year. Separately, Also, last week, Chairman Debbie Stabenow (D-MI) announced that the Committee will be seeking public comment through May 1st on the reauthorization of the CFTC.

Senate Banking Committee Begins its Examination of Housing Reform

During a February 28th hearing, Chairman Johnson (D-SD) and Ranking Member Crapo (R-ID) expressed their mutual interest of their intention to pass bipartisan legislation in this Congress to reform the FHA. The show of bipartisanship stands in contrast to House, as so far during their hearings on this issue, leading Republicans and Democrats on the Financial Services panel have been divided over the approach to FHA reform. As things stand, it is expected that the President's budget will estimate a shortfall in the FHA's insurance fund and, should recent changes such as higher insurance premiums not cover the gap, a bailout could be necessary at the end of the fiscal year. While the Senate Banking Committee appears poised to push forward with a broad reforms, it was worth noting that Senator Warren, agreed with a witness from the Mortgage Bankers Association, who cautioned that addressing the FHA's budgetary issues should be done in concert with reforming Fannie Mae and Freddie Mac as approaching one without the other could push more risk into the taxpayer owned GSEs.

Financial Transactions Tax Legislation Introduced
Following on Eurozone efforts, on February 28th, Senator Tom Harkin (D-IA) and Representative Peter DeFazio (D-OR) introduced legislation to place a tax on certain trading activities undertaken by banking and financial firms. The legislation would levy a 0.03 percent tax on many non-consumer financial trading activities such as of stocks, bonds and other debt issuance, derivatives contracts, options, puts, forward contracts and other financial instruments; however, the legislation excludes mortgage and credit card loan transactions and the buying of currency. Harkin was joined by Senators Bernie Sanders (I-VT) and Sheldon Whitehouse (D-RI) and Defazio by 19 House cosponsors.

While the Obama Administration has opposed financial transactions tax proposals in the past, Senator Harkin indicated his hope that this could change, saying that he viewed a transactions tax as a good candidate for inclusion in a 'grand-bargain' budget deficit deal because the proposal could generate up to $352 billion in revenues over 10 years. Despite the Senator's optimism it is worth noting that during his confirmation process, Treasury Secretary Lew maintained the Administration's resistance to the tax, saying: "The administration has consistently opposed a financial transactions tax on the grounds that it would be vulnerable to evasion, create incentives for financial reengineering, and burden retail investors."

Bill to Repeal Dodd-Frank Act Introduced
On February 27th, Senator Vitter introduced S. 20, a bill to repeal the Dodd-Frank Act. Vitter was joined by Senators Crapo (R-ID), McConnell (R-KY), Paul (R-KY), Johanns (R-NE), Flake (R-AZ), Coburn (R-OK), Blunt (R-MO), Shelby (R-AL), Heller (R-NV), Toomey (R-PA), Lee (R-UT), Chambliss (R-GA), Cruz (R-TX), Alexander (R-TN), Inhofe (R-OK), Cornyn (R-TX), Risch (R-ID), and Isakson (R-GA). While there is discussion of possible bipartisan technical corrections to the Dodd-Frank Act during the 113th Congress, any effort to repeal the financial reforms is likely to be symbolic only.

House of Representatives
Tax Reform is "Number One"
Last week, House Speaker John Boehner's (R-OH) Office confirmed that he has reserved H.R. 1 for legislation to overhaul the tax code. H.R. 1 is traditionally assigned to a major policy goal of the majority party. Noting the reservation, Chairman of the House Ways and Means Committee Dave Camp (R-MI) said he has a "green light" to pursue a revenue-neutral and individual tax code overhaul this year but would not signal when the Committee would release a proposal or if the package would even be voted on this year.

Waters Supports Raising Member Business Lending Cap
Speaking before the Credit Union National Association ("CUNA") Government Affairs

Conference last week, Ranking Member of the House Financial Services Committee Maxine Waters (D-CA) said she supports legislation (H.R. 688) introduced by Representatives Ed Royce (R-CA) and Carolyn McCarthy (D-NY) to raise the cap on member business lending (MBL). The legislation, which would allow credit unions to raise new forms of capital, was stalled during the lame duck session last year. Waters said she also supports a bill introduced in the 112th Congress by Representatives Peter King (R-NY) and Brad Sherman (D-CA) to allow credit unions to raise private capital.

Financial Services Committee Approves Budget Views and Estimates Letter
On February 26th the House Financial Services Committee approved is budget views and estimates letter in a 29 to 22 vote. The letter will be used by the Appropriations Committee when drafting the annual budget resolution. While there were no amendments to the letter offered, Democrats on the panel stressed that it was premature to discuss the FY 2014 budget, as the President has not released a proposal.

Executive Branch
Federal Reserve
Bernanke Appears Before House and Senate in Semiannual Monetary Policy Review
Last week, Chairman of the Federal Reserve Ben Bernanke appeared before the Senate Banking Committee and the House Financial Services Committee to provide the Fed's semiannual monetary policy report. In testimony before the two bodies, Bernanke sought to allay market concerns about quantitative easing. Bernanke said the Fed took the risk of prolonged low interest rates "very seriously" but that, presently, the low rates are reducing risk by encouraging firms to relay on "longer-term funding and by reducing debt service costs for households and businesses." Bernanke said that the economy continues to "expand at a moderate if somewhat uneven pace," but cautioned that sequestration and high deficits could harm the progress that has been made toward recovery.

Bernanke also addressed several issues related to the Dodd-Frank Act, saying there are a few provisions of the financial reforms that could be improved through modifications, such as the push-out provision for derivatives. The Fed Chairman also touched on regulators' progress with the Volcker rule, saying agencies are almost done with the rulemaking and are working to ensure it can be applied to various institutions consistently. There were few fireworks during the two hearings; most notably, on the House side, when Chairman Hensarling (R-TX) shared his concerns about QE III and the decision making of the FOMC, but also on the Senate side, where Senator Warren (D-MA) pressed Bernanke on the process of ending too big to fail financial institutions.

Fed Proposes Financial Market Utilities Reserve Bank
On February 26th, the Fed requested comment on a proposed rule to amend Regulation HH in order to allow banks to establish and maintain accounts for systemically important financial market utilities, such as payment systems, central securities depositories, and central counterparties. The proposed rule implements portions of Title VIII of the Dodd-Frank Act, which calls for the creation of a Reserve Bank to pay interest on the balances maintained by a designated financial market utility.

CFTC

Commissioner Wetjen Proposes Change to SEF Rule

Last week, CFTC Commissioner Mark Wetjen, in a confidential agency memorandum, which was subsequently leaked to the press, offered an amendment to the pending draft final rulemaking on swap execution facilities, which the CFTC is expected to vote on in April. Wetjen, who is seen as the swing vote for this rulemaking, has proposed to change a section of the rule that, among other things, modifies how many counterparties users of certain trading systems must engage when conducting a transaction. The current draft rule would require five requests for quotes, but Wetjen's proposal would allow for SEF users to issue a minimum of two requests. The amendment is intended to increase price transparency and foster greater participation in the market beyond large dealers. Stakeholders who will be using the SEFs, such as asset managers and insurance companies, had voiced concerns about the initial proposal, saying that it will increase costs and force migration to other markets. Not surprising these groups are now on the record statement in support of Wetjen. However, late on Friday, Better Markets, issued a scathing critique of the proposal, where among other points made, the group disputed that lowering the number of quotes would encourage more transaction to migrate to SEFs.

FDIC

FDIC and European Commission Discuss International Resolution Plans

On February 25th, the FDIC announced the results of a recent meeting between the agency and the European Commission (EC) earlier in the month. The FDIC and EC met on February 20th to discuss issues surrounding the resolution of banks and systemically important financial institutions (SIFIs). According to an FDIC press release, the topics discussed by the two regulatory bodies include: the EC's proposed directive on bank recovery and resolution; deposit guarantee regimes; the FDIC's work on planning for SIFI resolutions; and future initiatives that might be undertaken related to cross border cooperation. The meeting was the first of several planned working group sessions this year.

SEC

SEC to Vote on Regulations to Deal with High Frequency Trading

On March 6th, the SEC will vote on whether to propose rules to help prevent technology-related market disruptions. Reg SCI would require that the basic technology of exchanges, trading systems and clearing agencies, such as clearing houses and broker dealers, meet a new set of standards. Among other things, the regulation also requires that business operating in this space must conduct business continuity testing and provide certain notifications regarding systems disruptions and other events. Reg SCI has become one of the SEC's top priorities following recent disruptions such as the May 2010 Flash Crash and Knight Capital.

FHFA

Fitch Cautions Fannie and Freddie Reforms May be Uphill Battle due to Profitability, Market Share

Last week Freddie Mac announced $4.5 billion in net fourth-quarter income, revising its full-year earnings estimate for 2012 to $11 billion. Last year was the first year since 2006 that Freddie recorded a profit. Following the GSE's announcement, Fitch Ratings released a report warning that the profitability and large market share of the GSEs will impact lawmakers' ability to wind them down. In addition, it is anticipated that the White House will include in its annual budget proposal that Fannie and Freddie will be profitable enough in the short-term to help reduce the budget deficit, meaning reforming the entities in a way which does not have profits flow to taxpayers could be spun an increase to the deficit. Fitch also notes that uncertainty resulting from pending rules for lending practices and bank capital "continues to be an important constraint and private appetite for mortgage assets is likely to remain muted," making Fannie and Freddie ever more valuable.

<u>Miscellaneous</u>

BPC Proposes Plan to Reform Housing Finance Market

On February 25th, the Bipartisan Policy Center released a proposal to reform the nation's housing finance system and spur debate about the government's role in housing finance. The report recommends phasing out the government-sponsored entities Fannie Mae and Freddie Mac over a ten year period and creating a new system of private capital backed by the federal government only in times of economic distress. Acting as a "public guarantor," the federal government would support the financing of loans up to $275,000, lower than the current Fannie and Freddie loan limit of $625,500. As public guarantor, the government would qualify financial institutions to serve as issuers of mortgage-backed securities and ensure capitalization of institutions but would no longer buy and sell mortgages or issue mortgage-backed securities.

The approach taken by the BPC is similar to proposals made by the Mortgage Bankers Association in 2009 and Representatives John Campbell (R-CA) and Gary Peters (D-MI) in the 112th Congress. While a legislative overhaul of the GSEs has long been on the agenda, the Obama Administration has been wary to tackle reforms that could upset a slowly recovering housing market. Additionally, there remain gaps in policy preferences between the two parties; Republicans favoring replacing GSEs with a fully privatized system, a non-starter to Democrats. The BPC report sought to strike a balanced approach, stressing that continued involvement of the federal government is essential to ensuring that mortgage credit remains available but that the private sector should be playing a larger role in bearing credit risk.

ICBA Lays Out Legislative Priorities for 113th Congress

Last week, the ICBA laid out its Plan for Prosperity policy platform for the 113th Congress. Under the plan, the ICBA will continue its push for regulatory relief for small banks, including seeking exemptions from certain new mortgage rules, creating a designated Treasury assistant secretary for community banks, and strengthening the bank exam appeals process. Among their legislative goals, the ICBA has proposed:

- Reducing annual privacy notice redundancies to cut paperwork;
- Easing municipal advisor registration burdens to help serve local governments;
- Reforming the CFPB to ensure more balanced regulation;
- Offering relief from accounting and auditing expenses for publicly traded institutions;
- Supporting mutual banks with new charter and dividend rules;
- Requiring rigorous and quantitative justification of new rules
- Supporting additional capital for small bank holding companies;
- Cutting the red tape in small-business lending; and
- Facilitating capital formation by reforming Subchapter S corporation regulations and extending the net-operating-loss carry-back.

New Jersey Legalizes Internet Poker Gaming

On February 26th, Governor Chris Christie signed a law legalizing internet poker, and allowing for interstate compacts permitting players to wager at the same virtual poker tables. The law makes New Jersey the third state to permit online gaming following Delaware and Nevada. Christie had previously vetoed the proposal earlier in the month, promising he would sign this slightly revised version which raised the tax rate to 15 percent from 10 percent. None of the three states have begun to accept bets and there is no clear indication of when states will begin to negotiate the interstate contracts. Nor is it fully clear if these state efforts supplant or exacerbate the need for Federal action in the internet gaming space.

Upcoming Hearings

On Tuesday, March 5th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Monetary Policy and Trade will hold a hearing titled "Near-Zero Rate, Near-Zero Effect? Is 'Unconventional' Monetary Policy Really Working?"

On Tuesday, March 5th at 10am, in B-308 Rayburn, the House Appropriations Subcommittee on Financial Services and General Government will hold a Treasury overview as part of fiscal 2014 appropriations.

On Tuesday, March 5th at 10am, in 1300 Longworth, the House Agriculture Committee will hold a hearing on the state of the rural economy.

On Tuesday, March 5th at 10:30am, in 608 Dirksen, the Senate Budget Committee will hold a hearing on efforts to reduce the deficit by eliminating wasteful spending in the tax code.

On Tuesday, March 5th at 11am, in 1100 Longworth, the House Ways and Means Subcommittee on Oversight will hold a hearing on the tax-related provisions in the Patient Protection and Affordable Care Act and Health Care and Education Reconciliation Act of 2010.

On Wednesday, March 6th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises will hold a hearing on the role Fannie Mae and Freddie Mac played in the 2008-09 financial crisis.

On Wednesday, March 6th at 2pm, in 2359 Rayburn, the House Appropriations Subcommittee on Financial Services and General Government will hold a Small Business Administration Overview as part of fiscal 2014 appropriations.

On Thursday, March 7th at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing titled "Patterns of Abuse: Assessing Bank Secrecy Act Compliance and Enforcement."

On Thursday, March 7th at 10am, in 210 Cannon, the House Budget Committee will hold a hearing to allow members of the House to give their views on budget issues.

On Wednesday, March 13th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Housing and Insurance will hold a hearing on the competitive advantages the Federal Housing Administration has relative to private mortgage insurers and how those advantages contribute to the crowding out of private capital in housing finance.

On Thursday, March 14th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Oversight and Investigations will hold a hearing on the role of the Financial Stability Oversight Council and its role in determining which institutions are "too big to fail."

On Tuesday, March 19th at 10am, in 2128 Rayburn, the House Financial Services Committee will hold a hearing on the Federal Housing Finance Agency.

On Wednesday, March 20th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on how federal regulations affect small financial institutions.

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