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FINANCIAL SERVICES REGULATORY REFORM UPDATE

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As the August 2nd deadline to increase the debt limit draws nearer, the "Biden group," has redoubled its efforts. The group recently increased the number of meetings scheduled and will be meeting three times a week for the remainder of June in an attempt to draft deficit reduction legislation for consideration before the July 4th recess, as noted in last week's update, and will likely meet four times in the coming week.

In remarks to the press after the group's meeting on June 14th, Vice President Biden said that they are beginning to get "down to the real tough stuff." Biden went on to say that he is "confident" that the group will reach an agreement that raises the debt limit and makes progress toward reducing the deficit. House Majority Leader Eric Cantor (R-VA) echoed Biden's remarks, saying that a sense of urgency has produced "very substantive" discussions on the deficit.

The discussions from the group's most recent meeting on June 15th focused on controlling spending through automatic spending cuts and tax increases. Rep. Chris Van Hollen (D-MD), a member of the group, said that there is broad support within the group for "a mechanism that ensures deficit reduction" such as spending caps that trigger automatic cuts. Van Hollen also reported that Democrats laid out for Republicans a "menu of options" designed to diminish tax expenditures to corporations. Some of these options included: ending oil and gas subsidies, closing special interest tax code loopholes and ending tax breaks for corporate jets. According to aides, other issued discussed at this meeting included discretionary spending and a possible extension of payroll tax breaks to stimulate the economy.

While law makers have been relatively quiet on the details of the group's discussions, Rep. James Clyburn (D-SC) emerged from the June 15th meeting "very optimistic" that the group would be able to put forward a proposal. Sen. Jon Kyl (R-AZ) told reporters the group set July 1st as the goal to reach a final agreement.

On Thursday, the group held its third closed-door gathering of the week, which largely focused on entitlement programs unrelated to healthcare, according to Cantor. These programs, including military

and federal workers' pensions and those related to agriculture, account for 12% of the budget. Biden stated afterwards that the group is determined to find $4 trillion in savings and demonstrate to the world (particularly its financial markets) that the U.S. is committed to mitigating its debt problem. Contrarily, Sen. Kent Conrad (D-ND) expressed his fear that "they will come up with a plan that doesn't fundamentally change the trajectory of our debt but just gets by this debt limit vote… That would be a real missed opportunity."

Despite the appearance of progress and hopeful remarks from members of the negotiating group, the disparity between the two sides of the aisle remains great. More than $1.1 trillion dollars of domestic and foreign appropriations separates the two negotiating groups. Another possible sticking point is Medicare. While Republicans have called for savings to come from cuts to the Medicaid program, Senator Chuck Schumer (D-NY) categorically stated that they "will not allow cuts to seniors' benefits."

WALL STREET TO CURB T-BILL USE IN CASE OF U.S. DEBT DEFAULT

As the deadline of August 2nd nears for the U.S. to breach its debt ceiling, it appears that banks are preemptively preparing to curb their use of U.S. Treasuries in order to hedge against the financial catastrophe that could ensue from a failure to raise the debt limit. It was reported that industry executives, speaking anonymously, stated that they will be keeping more cash on hand "as a contingency measure" and lowering their reliance on the use of Treasuries in early August. Almost 40% of the U.S.'s debt is used as collateral for repurchase, futures and swaps transactions, according to JPMorgan Chase, and this is where the danger lurks in terms of the U.S. missing payments.

Normally, because U.S. Treasuries are deemed to be such a safe investment, they are used to back these transactions quite inexpensively. Now, as stated by Matthew Zames, an executive with JPMorgan Chase and the chair of the Treasury Borrowing Advisory Committee, "a default could trigger a wave of margin calls and widening of haircuts on collateral, which in turn could lead to deleveraging and a sharp drop in lending." For now, the U.S. Treasury yields are showing no signs of distress, though the market is being closely monitored as the U.S. approaches the debt ceiling.

On a related note, Douglas Elmendorf, the Director of the Congressional Budget Office, spoke at an event sponsored by the Christian Science Monitor earlier this week and warned that it would be a "dangerous gamble" to allow the U.S. to default on its debt. He does not believe default is likely, but posited that the mere possibility could be enough to frighten investors and cause interest rates to increase. He stated that "…any government that has borrowed as much as ours has borrowed, and will need to borrow as much as ours will need to borrow, cannot take the views of its creditors lightly. Even a small increase in the perceived risk of Treasury securities would be very expensive for the country."

HOUSE FINANCIAL SERVICES COMMITTEE MEMBERS PRESS REGULATORS ON INTERNATIONAL HARMONIZATION

On June 16th, the House Financial Services Committee held a hearing to examine the international aspects of financial regulatory reform. With ongoing concerns that Dodd-Frank reform will put the United States at a competitive disadvantage compared to international financial institutions, lawmakers pressed regulators on how they are working to achieve global harmonization.

Committee members were particularly concerned with the creation of a capital surcharge for systemically important financial institutions (SIFIs). In response to concerns that U.S. capital standards would far surpass those set out by Basel III, Fed Governor Tarullo said that the rationale for SIFI surcharge regulations "complements" the rationale for Basel III rules. The SIFI surcharge goes beyond the Basel III capital requirements by taking into account the size, interconnectedness and consequences of the failure of a SIFI. Other key areas of concern among members included derivatives regulation, living wills and orderly wind down provisions and the Volcker Rule. Regulators stressed their commitment, as they have for a number of weeks, to working with their international counterparts and harmonizing global financial reform with US regulations.

In addition to hearing from the U.S. regulators, the Committee received testimony from prominent banking officials including representatives of JPMorgan Chase and Morgan Stanley. The bankers sought to convince the Committee that financial rulemaking will only serve to drive business overseas and curtail banks' ability to lend during a crucial time of economic recovery. The bankers cited derivatives rules and higher capital requirements as two of the most harmful rules to the US industry. While Republican lawmakers largely shared the bankers' concerns, Ranking Member Barney Frank warned against weakening regulations merely to protect banks' profits.

GOP TAKES ANOTHER STAB AT HINDERING CFPB AND FINANCIAL REGULATORS

In another attempt to obstruct the Consumer Financial Protection Bureau's operations, GOP members of the House Appropriations Subcommittee on Financial Services introduced a measure on Wednesday that would cap the regulator's FY2012 budget (from the Treasury) at $200 million, and would subject the agency to the congressional appropriations process beginning in FY2013. The CFPB will be fully operational in just over a month, and was intended under Dodd-Frank to be an independent regulator, with 10-12% of Federal Reserve System expenses to be transferred to the CFPB as its annual budget (estimated at about $500 million). For FY2012, the Obama administration approximated that $329 million from the Fed would be needed in order to properly fund the new agency.

According to a statement by the House Appropriations Committee majority, "This new agency created by the Dodd-Frank legislation has not yet been fully constituted and many questions remain as to its authority and mission." This measure before the Committee would make the CFPB "more transparent and accountable to the taxpayer." The funding cap was included in a financial agencies spending bill that passed out of the Committee by a voice vote on Thursday, and would also limit aspects of the 2010 health care reform law. FY2012 funding for financial regulators would be 9% below current levels and $6 billion below Obama's FY2012 budget request.

SENATE AG COMMITTEE GRILLS CFTC CHAIR GENSLER

Testifying before the Senate Agriculture Committee, Chairman Gary Gensler stated that his agency's 51 Dodd-Frank final rulemakings "will be logical outgrowths of what we proposed," and if the final rule is "more than a logical outgrowth – if it's truly something new," then the CFTC would re-propose the rule altogether. This was in response to a question from Sen. Pat Roberts (R-KS), who was concerned about Gensler's earlier statement that the majority of the agency's 51 proposed rules would be changed before a final vote by the CFTC commissioners. Committee Chairman Debbie Stabenow (D-MI) echoed concerns stated in recent weeks by a variety of stakeholders and legislators, about the "timing and clarity" of the Dodd-Frank rulemaking process and the efforts to reconcile domestic and

international regulations. Gensler responded that the CFTC has the authority to "phase in" final rules so as not to upset financial markets, and that swap data repositories, clearing houses and swap execution facilities should be "open for business" for when "mandatory clearing, trading [and] transaction compliance" is phased in. He also stated that the international harmonization would be at least partially addressed by the proposed delay (discussed below) and a multitude of mutual recognition agreements regarding derivatives that will be signed by other countries. EU regulators are expected to make progress this fall on legislation regarding derivatives trading and clearing requirements.

CFTC VOTES TO DELAY EFFECTIVE DATE FOR SWAPS RULES UNTIL DEC 31ST

On June 14th, the CFTC voted unanimously to delay the effective date for the agency's swaps rulemaking to December 31, 2011 or when the final rules are completed. The delay only affects those rules that necessitate additional CFTC rulemaking to go into effect. Rules that are "self-effectuating," including regulations of portfolio margining and abusive swap authority, will still take effect on the original July 16th deadline.

The delay consists of two major measures: first, exemptions for covered entities from complying with provisions that include terms such as "swap," "swap dealer," "major swap participant," or "eligible contract participant;" and, second, exemptions for specific transactions undertaken by exempted commodities such as energy commodities.

The CFTC previously announced June 9th that they were considering a delay in order to provide certainty to the swaps community. In comments prior to the Commission's vote, CFTC Chairman Gary Gensler made clear that the delay should not be viewed as a delay in implementation of Dodd-Frank. Gensler said "there have been suggestions to delay implementation of the derivatives reforms included in the Dodd-Frank Act. That is not what today's [proposal] is….Instead, it provides the time necessary for the commission to complete the rulemaking process to implement the Dodd-Frank Act."

SEC FOLLOWS CFTC'S LEAD IN PROVIDING CLARITY AND RELIEF TO SWAPS MARKET

As the CFTC voted to extend the effective date for swaps rules, the SEC announced on June 10th that it will be taking a number of steps to provide clarity and "temporary relief" to entities covered by the agency's swaps rules. The Commission proposed rules which would exempt all transactions made by clearing agencies undertaking "security-based swaps from all provisions of the Securities Act, other than the Section 17(a) anti-fraud provisions." The rule also exempts certain swaps from meeting requirements set forth in the 1934 Securities Exchange Act and the Trust Indenture Act.

Robert Cook, Director of the SEC's Division of Trading and Markets, said that these rules are a "first step in a series of actions the SEC intends to take in coming days to address effective date issues." In addition, the Commission will seek public comment on the creation of a "detailed implementation plan" that would lay out a new timeline for swaps rules. The temporary relief measures are already in effect; however, the SEC is still seeking public comment on the proposed rules through July 6th.

INDUSTRY CONCERNED WITH COMBINED EFFECT OF RULEMAKINGS

Recently, Assistant Secretary Phyllis Borzi of the Employee Benefits Security Administration at the Labor Department publicly commented on the Commodity Futures Trading Commission's (CFTC)

proposed regulation that would impact swap dealers and major swap participants in ERISA covered-plans. Borzi stated that this new definition "is not broadly intended to impose ERISA fiduciary obligations on persons who are merely counterparties to plans in arm's length commercial transactions," and unless the "counterparty has expressly represented that it is acting as a fiduciary; it will not be treated as one.

Industry stakeholders have also expressed concerns about how all of the rulemakings at the DOL, SEC and CFTC related to ERISA will eventually intersect or be harmonized. According to the American Benefits Council and the Committee on Investment of Employee Benefit Assets, the DOL's proposed fiduciary standard could turn swap dealers and major swap participants into ERISA fiduciaries with respect to plan counterparties. These industry representatives have filed comments with the CFTC, stating that Borzi's letter does not fully address their concerns about these new standards and rules effectively denying employee benefit plans access to legally engage in swap transactions. The author of the comment letter, Kent A. Mason, stated specifically that if the "swap dealer is a fiduciary, the swap would be a prohibited transaction, so that swaps with plans would have to cease… unless there is binding legal guidance issued on or before the finalization of the business conduct standards." He added that the guidance would have to come from the CFTC, and not the DOL, because this is the former's issue.

PCAOB ADOPTS RULES REGARDING BROKER-DEALER INSPECTION RESPONSIBILITIES

On June 14th, the Public Company Accounting Oversight Board ("PCAOB") approved rules to implement sections of Dodd-Frank dealing with audits of securities broker-dealers. The rules adopted include rules to create an interim inspection program "for registered public accounting firms' audits of brokers and dealers." The temporary rule authorizes the Board to begin inspections in order to gain insight into how to structure a permanent inspection program. The Board expects to be issuing final rules on a permanent inspection program in 2013. PCAOB also outlined rules for "assessing and collecting" broker and dealer fees to fund the Board's audits. PCAOB Chairman James R Doty said that the "actions today are an important step in oversight of the audits of brokers and dealer."

UPCOMING HEARINGS

On Tuesday, June 21st at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing titled "Cybersecurity and Data Protection in the Financial Sector."

On Tuesday, June 21st at 2pm, in 1100 Longworth, the Joint Economic Committee will hold a hearing titled "Spending Less, Owing Less, Grow the Economy."

On Wednesday, June 22nd at 9:30am, in 1100 Longworth, the House Ways and Means Subcommittee on Health will hold a hearing on the findings in the 2011 annual report of the board of trustees of the Social Security system.

On Wednesday, June 22nd at 10am, in 2128 Rayburn, the House Financial Services Committee will mark-up pending legislation related to Ex-Im Bank reauthorization, small business capital, debt collection and exempted securities issued by churches.

On Wednesday, June 22nd at 10am, in 2360 Rayburn, the House Small Business Committee will hold a hearing titled "The State of Small Business Access to Capital and Credit: The View from Secretary Geithner."

On Thursday, June 23rd at 10am, in 1100 Longworth, the House Ways and Means Subcommittee on Select Revenue Measures will hold a hearing on the impact of foreign direct investment on the U.S. economy, as well as how changes to the tax code might affect foreign-headquartered businesses.

On Thursday, June 23rd at 10am, in 210 Cannon, the House Budget Committee will hold a hearing on the long-term budget outlook prepared by the Congressional Budget Office.

On Thursday, June 23rd at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Domestic Monetary Policy and Technology will hold a hearing on pending legislation, H.R. 1495, the Gold Reserve Transparency Act of 2011.

On Thursday, June 23rd at a time TBD, in 2359 Rayburn, the House Appropriations Committee will mark up draft legislation that would make fiscal 2012 appropriations for programs related to financial services.

On Friday, June 24th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises will hold an oversight hearing on mutual funds.

On Wednesday, June 29th at a time TBD, at the National Computer Forensics Institute in Hoover, AL, the House Financial Services Committee will hold a field hearing on the threat that cybercriminals pose to individuals and financial institutions.