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FINANCIAL SERVICES LEGISLATIVE AND REGULATORY REVIEW

Week of July 25th, 2011

Once again, the nation's and the worlds attention was fixated on Washington this past week, as both parties continued to play an incredible game of chicken with the debt ceiling issue. President Obama called on both parties to "give him something to sign" by Tuesday, and although it seemed increasingly unlikely, both sides were able to reach a deal late on Sunday night. Despite the legislative uncertainty, markets seemed to have taken the whole thing in stride, with only moderate market fluctuations having occurred, and Treasury having announced next week's bond sales were to go off as planned. In non-debt ceiling related news, the Senate Banking Committee ramps up hearing nominations for top posts at the FDIC, OCC and CFPB, and the House Financial Services Committee grilled credit rating agencies who were forced to preemptively defend their potential downgrade of the U.S. credit rating. Finally, yet another data security bill was introduced in Congress, one which require notification to individuals by banks and other companies if any personal information has been compromised.

Leading the Week

By design, the serious legislative action on the debt ceiling started after the markets closed on Friday. First, despite a bumpy start, House Speaker John Boehner's (R-OH) finally prevailed when his debt plan was passed by the House of Representatives on Friday night, by a vote of 218-210. Boehner had more wrangling than he anticipated, with a significant number of House Republicans refusing to get on board with what the Speaker deemed the only alternative to Senate Majority Leader Harry Reid's (D-NV) Democratic plan. In the end, 22 Republicans and all Democrats dissented, and the vote was a full day later than planned because Boehner had to rewrite sections of his bill in order to get a sufficient number of his colleagues to toe the party line. Boehner's bill would moderately increase the debt ceiling, reduce the FY2012 budget by $22 billion and reduce federal spending over the next ten years by $915 billion. It would also create a "super Congress," comprised of 12 bipartisan Senators and Representatives, with the authority to reform Social Security, Medicare and other national programs.

In order to win over reticent House Republicans – the most conservative members in that chamber – Boehner agreed to add a provision requiring the passage of a balanced budget constitutional amendment in order to permit a second increase in the debt ceiling later in 2011. The initial provision would have simply required a vote on the balanced budget amendment, but this was deemed inadequate.

All this work, however, became obsolete later Friday night when the bill was introduced in the Senate with its contents stripped and replaced with Reid's own debt plan. However, the Reid plan was also summarily dismissed by the House on Saturday afternoon, when the House voted 173-246 on the bill, short of a majority and well short of the two-thirds majority needed for passage, which was required because Republicans brought up the bill under a suspension of House rules. Along with every Republican, there were 11 Democrats who voted against the Reid proposal. Then on Sunday, the Senate voted 50-49 against cutting off the filibuster of the Reid bill, which cleared the way for a McConnell – Biden negotiated "fall back plan." Late on Sunday evening, both the White House and leaders of the Congress announced that they had agreed to a framework to a deal. According to aides and a presentation made to House Republican members (attached to this email) the debt ceiling would be raised by $900 billion with an initial round of $917 billion in spending cuts made through the imposition of discretionary spending caps. A second debt ceiling increase of $1.5 trillion would be authorized if a bipartisan joint congressional committee (a/k/a a "Super Committee – comprised of six Republicans and six Democrats, half from each chamber) can come up with more than $1.5 trillion in additional deficit reduction (including the real possibility of comprehensive tax reform).

To give the committee an incentive to come to agreement and for Congress to approve it on an up-or-down vote, across-the-board spending cuts would kick in, applying to most discretionary and mandatory programs, including Medicare and defense, if the committee's ideas were not enacted. The deal would also require a vote in each chamber on a balanced budget amendment after Oct. 1 but before the end of 2011.

In what one day may be viewed as a profile in courage, Obama's agreement to accept responsibility from the Congress for raising the debt ceiling in two parts: roughly half of it now and the balance at the end of the year, subject to a Congressional resolution of disapproval, shifts responsibility for raising the debt ceiling from the purview of the Congress to one of the Administration.

Legislative Branch

House of Representatives

House Subcommittee grills credit rating agencies on U.S. credit downgrade: On Wednesday, the House Financial Services Subcommittee on Oversight and Investigations convened a hearing entitled, "Oversight of the Credit Rating Agencies Post Dodd-Frank." There were two panels of witnesses, the first comprised of SEC, Fed and OCC officials, and the second comprised of executives from credit rating agencies, an academic and an executive from a state public employees' retirement association. In the latter panel, members from both sides of the aisle, including Chairman Spencer Bachus (R-AL) and Rep. Michael Capuano (D-MA), berated the rating agencies for their failures leading up to the financial crisis.

In addition to examining the progress that has been made in the rating agencies' credibility and ethical standards since the financial crisis, the second panel also delved into the debt crisis and the United States' potential downgrade in credit rating. Rep. Francisco Canseco (R-TX) asked the Standard & Poors' (S&P) Deven Sharma if it is "interference on the part of the credit agencies, to be stepping in at this stage." Both S&P and Moody's have indicated that they would lower the United States' AAA rating if Congress does not create around $3-4 trillion in deficit reduction over the next ten years - even if the country avoids a default. (Some experts put the odds of a downgrade at 50%). Sharma stated that his company's duty is to its investors, to provide an "independent view and future-looking view," and he expressed his opposition to the concept of government regulations that would set bond ratings. "It is particularly important that rating methodologies not become subject to influence by one or more countries seeking to benefit its own rating," said Sharma, "which would undermine the independence, comparability and value of ratings to all."

Rep. Mike Fitzpatrick (R-PA) raised the question of behind-the-scenes talks between Treasury officials and the credit rating agencies, and whether the former had put any pressure on the latter. Sharma explained that these meetings between the administration and his firm are routine before making a rating assessment (as was confirmed by others present at the hearing).

House Education and Workforce Committee hears testimony on DOL fiduciary definition: On July 26th, the House Education and Workforce Committee met to hear testimony on the Department of Labor's proposed definition of "fiduciary." While the hearing was intended to focus on the impact of the fiduciary definition on retirees, the discussion was broadened to generally address all unintended consequences of the new definition, including its impact on advisors and industry. The hearing also digressed to include a discussion of the impact a U.S. default or downgrade would have on pension funds. Phyllis Borzi, assistant secretary for the DOL's Employee Benefits Security Administration said that a default would put fiduciaries in a difficult situation and have a "profound effect" on 401(k) plans and retirees.

In discussing unintended consequences, many lawmakers and the second panel of witnesses—which included experts from a variety of sectors including academia, law and industry— stressed that the fiduciary rules should be re-proposed for additional public comment and to include all required exemptions. Lawmakers also expressed concerns over harmonizing DOL's fiduciary definition with that of the SEC and that of the CFTC. Despite the general disapproval of the Department's rules, Borzi defended the rulemaking and stressed that the rules are needed to update a narrow definition that does not adequately protect consumers.

Senate

Senate Banking Committee considers administration nominees: Earlier this week, the Senate Banking, Housing and Urban Affairs Committee convened to consider the nominees for chairman of the FDIC (Martin Gruenberg), the comptroller of the currency (Thomas Curry), and an independent, voting member of the Financial Stability Oversight Council (FSOC) as its expert in the insurance market (S. Roy Woodall, Jr.). Committee Chairman Tim Johnson (D-SD) was interested in Woodall's approach to designating insurance firms as systemically important financial institutions (SIFIs). Woodall explained that this would have to be determined on a case-by-case basis, and that firms solely offering traditional insurance products would likely fall outside this category. Those closer to an AIG model might come under increased scrutiny, however.

In responding a question from Ranking Member Richard Shelby (R-AL) about Basel III capital requirements, both Curry and Gruenberg stated their support for the new minimums and the significance of Basel III in preventing another financial crisis. Gruenberg noted that the FDIC is a member of the Basel Committee and U.S. banks tend to hold more capital than their international counterparts. Curry also added that it is critical for capital to be in place *before* a crisis, because this is when the need is greatest. Curry also spoke about his willingness to work hand-in-hand with the new Consumer Financial Protection Bureau on any issues with overlapping jurisdiction. Both Curry and Gruenberg also said that federal regulators continue to examine the controversial "skin-in-the-game" rule for qualified residential mortgages, in which mortgage originators would be required to retain a 5% stake for home loans in which a borrower put down less than 20%. The comment period on this proposed rule has already been extended and hundreds of responses received, which the FDIC will continue to review.

Cordray nomination hearing set for August 4th despite opposition to director position: On August 5th, two weeks after the official start date of the CFPB, the Senate Banking Committee will hold a nomination hearing to consider Richard Cordray to be the CFPB Director. In announcing the hearing, Chairman Tim Johnson (D-SD) said he hopes the hearing is the first step toward a quick confirmation. A sign that Johnson's hopes for a speedy confirmation are realistic can be seen in a letter written by a number of business executives to the Banking Committee supporting Cordray's confirmation. The letter expresses support for Cordray based on his "intelligence, pragmatism, integrity, and service-oriented mindset" in executing his duties as the Ohio county treasurer, state treasurer and Attorney General.

Despite the hopes of Chairman Johnson and the growing support of business for Cordray's nomination, the confirmation process will likely still be contentious. Republicans oppose the nomination of any director without structural changes being made to the CFPB and have a filibuster proof block on any nominee. Additionally, Ranking Member Richard Shelby (R-AL) has been vocal in his opposition to the Bureau, saying that the agency lacks accountability and places "far too much power… in the CFPB director."

Carper-Blunt introduce Data Security bill: On July 28th Senator Carper, joined by Senator Roy Blunt, introduced legislation (S. 1434) that would require businesses and federal agencies to adopt data security measures and mandates the disclosure to individuals if a breach occurs that compromises their personal data. The bill would be applied broadly, as it defines a covered institution as any company defined as a financial institution under the Graham-Leach-Bliley Act, as well as firms covered by the Fair Credit Reporting Act or any other business or individual that "maintains or communications sensitive account information or sensitive personal information. Like other data privacy bills introduced this year, the most controversial provision deals with the notification requirement. Under Carper-Blunt, covered institutions would be required to provide notice only if an investigation of a breach incident demonstrated that the information obtained is "reasonably likely to be misused in a manner causing substantial harm or inconvenience" to consumers. The bill has been referred to the Senate Banking Committee, but with neither Carper or Blunt on the committee it is unclear whether this legislation has any legs. However, with a whole mix of privacy bills floating around the Senate, it certainly could be incorporated as part of a major bill.

Executive Branch

SEC

SEC approves rules to monitor large traders: On July 26, the SEC unanimously agreed to adopt a reporting regime which would allow the Commission to better monitor and track the market activity of large traders. The rule requires large traders to self-identify and register with the SEC using a newly designed form. The rule also directs certain broker-dealers to maintain records and report and monitor transactions of large traders.

The SEC believes that the large trader rule will impact approximately 400 firms and approximately 300 broker-dealers who fall under the definition of "those whose trades in exchange-listed securities equal or are more than two million shares or $20 million in any one day, or 20 million shares or $200 million during any calendar month." For those who do fall under the large trader definition, it could result in additional costs of approximately $31 million across the industry. These costs are partially a result of the need for broker-dealers to redesign their EBS systems to allow for reporting of unique large trader identifying number.

The large trader rule will be effective 60 days from the publication date in the Federal Register. After the effective date, large traders have two months to comply with the additional identification requirements while broker-dealers have seven months to come into compliance. SEC Chairman Mary Schapiro said that the rule is a precursor to a more thorough consolidated audit trail designed to capture customer and transaction information across markets.

SEC and CFTC request public comment on report on international swaps rules: On July 20th, the SEC and CFTC published a notice requesting public comment on a joint study to examine international derivatives regulation mandated by the Dodd-Frank Act. The law directs the agencies to study and report to Congress on swap and clearinghouse regulations in the U.S., Asia and Europe in order to identify areas where regulation is similar and areas where harmonization is appropriate. The report "also must identify major dealers, exchanges, clearinghouses, clearing members, and regulators in each geographic area and describe the major contracts (including trading volumes, clearing volumes, and notional values), methods for clearing swaps, and the systems used for setting margin in each geographic area." In addition to seeking comment on the report, the SEC and CFTC will be holding a joint roundtable discussion on August 1st to discuss international aspects of implementing derivatives rules.

Treasury

U.S. bond sales to take place as scheduled next week: The Treasury Department will be holding its usual bond auctions on Monday, August 1st for $27 billion in three-month T-bills and $24 billion in six-month T-bills. Treasury officials announced that $87 billion in U.S. securities will also mature next week, and thus these bond sales will allow the Treasury to refinance the maturing securities without adding any debt to the statutory limit. The bond sales are the exact amounts of the auction that occurred one week prior, and the announcement cleared up any speculation over a postponement or a sale that was conditioned on an increase in the debt ceiling.

Elizabeth Warren to return to academia: On Tuesday, the Treasury announced that, effective August 1, Raj Date—current associate director of research, markets and regulation— will replace Elizabeth Warren as advisor to Treasury Secretary Geithner. Warren will be returning to her teaching position at Harvard a year after President Obama tapped her to oversee the establishment of the CFPB. In announcing Warren's departure, Geithner praised Warren for her efforts and set the stage for Date to replace her. Geithner said Date has an "impressive background" and he is pleased he will help the CFPB move forward with its "important work." Despite Warren's insistence that she 'needs a break' from Washington, supporters have begun a "Draft Elizabeth Warren" campaign to encourage Warren to run against Senator Scott Brown in the coming elections. The campaign has already raised over $50,000 dollars for a possible Warren Senate run in a few short weeks.

Money Market Funds seek to bolster liquidity due to uncertainty caused by lack of debt deal: With almost no time left until the Treasury's set date for default, money market funds are beginning to increase their liquidity and stockpile cash. On Wednesday, news reports indicated that money market funds—which hold approximately $338 billion of US government debt—are taking a number of steps to shore up their business in the event of a default. Funds are shunning one-month Treasury notes, reducing the amount of time they are willing to lend to banks, and boosting the amount of cash on hand to meet client redemptions. Despite the efforts to bolster their liquidity, it is unlikely that money market funds would be forced into selling should a downgrade occur. Funds rated triple A would be able to continue to hold less robust securities so long as the US maintains a single A rating or better.

UPCOMING HEARINGS

On Tuesday, August 2nd at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing titled "Housing Finance Reform: National Mortgage Servicing Standards."

On Wednesday, August 3rd at 9:30am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance and Investment will hold a hearing on the housing finance system, focusing on the to-be-announced market.

On Wednesday, August 3rd at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity will hold a hearing titled "Legislative Proposals to Determine the Future Role of the Federal Housing Authority, the Rural Housing Service and the Government National Mortgage Association (Ginnie Mae) in the Single- and Multi-Family Mortgage Markets."

On Wednesday, August 3rd at 2pm, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Subcommittee on Financial Institutions and Consumer Protection will hold a hearing on debt financing in the domestic financial sector.

On Thursday, August 4th at 10am, in 2128 Rayburn, the House Financial Services Committee will hold a hearing on an independent study conducted by the Boston Consulting Group on proposals to overhaul the Securities and Exchange Commission. The hearing was originally scheduled for June 3rd.

On Thursday, August 4th at 2pm, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a confirmation hearing on the nomination of Richard Corday to be the first director of the Consumer Financial Protection Bureau.

On Friday, August 5th at 10am, in 2128 Rayburn, the House Financial Services Committee will hold a hearing on the exposure of U.S. banks to the debt crisis in the European Union.

On a date TBD, 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 "What Went Wrong at the Financial Crisis Inquiry Commission?"

On a date TBD, in 2128 Rayburn, the House Financial Services Committee will hold a hearing to receive the Treasury's annual report on the state of the international financial system.

On a date TBD, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on the Small Business Lending Fund. This was initially scheduled for April 6th.