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FINANCIAL SERVICES LEGISLATIVE AND REGULATORY UPDATE

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It was all debt ceiling again this week, and as of this past Friday there are 25 days until the August 2nd default date, but only 14 days until the July 22nd deadline imposed by the President to give Congress enough time to draft the legislation. Demonstrating the urgency behind reaching a deal on the debt ceiling, President Obama called House and Senate leaders to the White House on Thursday and there were promises made to return on Sunday. The jobs report on Friday added more bleak news with only 18,000 jobs added in June, putting even more pressure on legislators to start moving forward with solutions for a fragile U.S. economy. In non-debt ceiling news the CFTC finalized its definition of agricultural commodity, the SEC walked away from a lease, and the liberal democrats tried to re-raise the Glass-Steagall flag.

Leading the Week

Despite the frenetic activity towards the end of the week, more speculation is surfacing that a deal may not be reached by August 2nd, and that multiple short-term deals – "kicking the can down the road" – may be the undesirable but inevitable alternative. And even though it has stated otherwise, the Treasury Department, hedging against potentially unsuccessful negotiations, has begun internal discussions on what can be done to stave off default. Senior lawmakers convened at the White House on Thursday to discuss their positions on raising the debt ceiling. Congressional leadership will also return there on Sunday and "will at least know where each other's bottom lines are and will hopefully be in a position to then start engaging in the hard bargaining that's necessary to get a deal done," according to the President. Some reports have Obama and House Speaker John Boehner (R-OH) set to compromise on a major $4.5 trillion deal with $1 trillion in tax increases, while others caution that this is overly optimistic. Boehner himself opined that "I don't think this problem has narrowed at all in the last several days" and "it's not like there is some imminent deal about to happen."

There is intense concern amongst the left flank of the Democratic party, epitomized by a recent letter from the Congressional Progressive Caucus to the President on Thursday, insisting that cuts to entitlement programs such as Medicare and Social Security should be off the table, and tax increases for the top bracket of Americans should be included in any deal that is made. The letter comes on the heels of Minority Whip Steny Hoyer (D-MD) stating earlier this week that House Democrat votes would likely be needed in order to pass a budget deal.

As was noted above, the Treasury has begun clandestinely exploring options to avoid a default on U.S. debt and any financial meltdowns that might ensue. Mary Miller, the Assistant Secretary to Financial Markets, has led contingency planning sessions discussing *inter alia* whether the administration can delay payments to manage cash flows after August 2nd, prioritizing payments and, most dramatically, invoking the 14th Amendment of the Constitution to ignore Congress and continue issuing debt. President Obama has already reacted by stating that "I don't think we should even get to the constitutional issue."

Meanwhile, heavy-hitting naysayers continue to urge the GOP to stay strong and make no compromises on "meaningful fiscal reforms." The Club for Growth, a low-tax and limited-government advocacy organization, encouraged legislators to vote against an increased debt ceiling, even at the expense of financial markets, because of the important statement it would make about the size of government. Noting the partisan trend and inability to negotiate that has been present since the 2008 elections, former Rep. Tom Davis stated that he "wouldn't be shocked if you have to undergo a market tremor of some kind to move both sides."

Finally, as we noted last week, lawmakers are dealing with an increasingly tight schedule to make an agreement, draft and debate potentially major reforms to the tax code and other areas of law, and then schedule votes in both the House and Senate. Because of this we anticipate that plans for a grand bargain will dissipate and a more workable short term solution will be enacted, eventually. Though, depending on how it is structured, it could take a failed vote and an adverse market reaction before Republicans are convinced to vote for the proposal.

Legislative Branch

House of Representatives

House lawmakers pursue GSE reform with support from industry: Despite the clear indication from last week's hearing that the Senate is apprehensive towards moving forward on housing finance reform, House lawmakers are readying a proposal to overhaul mortgage finance government-sponsored enterprises (GSEs). Representatives Gary Miller (R-CA) and Carolyn McCarthy (D-NY) are expected to introduce the legislation this coming Wednesday that would replace government sponsored mortgage issuers, Fannie Mae and Freddie Mac, with a single institution responsible for issuing mortgage-backed securities guaranteed by the government. Unlike Fannie and Freddie, which were accountable to private shareholders, the new model's profits would go directly to the U.S. Treasury.

The Miller-McCarthy proposal has already gained support from the housing and mortgage industry. The president of the National Association of Realtors said that his organization "supports the efforts of Reps. Miller and McCarthy in developing a comprehensive strategy for restructuring the secondary mortgage market that provides the federal government with a continued role so that qualified homebuyers can obtain safe and sound mortgage financing products in all markets and economic

conditions." However, House Republicans—who have repeatedly called for the federal government to get out of the mortgage market—are likely to oppose the overhaul. The chairman of the House Financial Services Committee, Spencer Bachus (R-AL), has said the goal for GSE reform should be full privatization of GSEs within five years. Next week, the Capital Markets Subcommittee will be considering a series of bills put forth by Rep. Scott Garrett (R-NJ) that would do just that, in addition to proposals for curbing Fannie and Freddie activities.

Liberal House members propose legislation to restore certain provisions of the Glass-Steagall Act: Democrats Maurice Hinchey (D-NY), Michael Capuano (D-MA), John Conyers (D-MI), Peter DeFazio (D-OR), Jay Inslee (D-WA) and Lynn Woolsey (D-CA), all stalwart liberals, introduced a bill earlier this week, H.R. 2451, that would restore certain provisions of the Banking Act of 1933, also known as the Glass-Steagall Act. Glass-Steagall was enacted after the Great Depression, and separated investment banks from commercial banks so as to prevent firms from using depositors' funds for risky trades. This is not a bipartisan measure and we do not expect the bill to gain traction in a Republican House.

Executive Branch

Treasury

TARP repayments will result in profit for Treasury: On July 5th, the Treasury announced that an additional $1.7 billion of TARP funds were repaid to the government. The repayment was made by the Bank of Montreal following its acquisition of the Marshall and Ilsley Corp. Currently, TARP proceeds amount to approximately $255 billion, which exceeds the Treasury's original $245 billion investment of funds. The Treasury estimates that the TARP program will ultimately rake in a positive return of up to $20 billion for the U.S. government.

Selections for two key banking regulatory positions could signal increased pace of nominations: This week, the Obama Administration announced that Mary Miller, currently the Assistant Secretary for Financial Markets at the Treasury, is the nominee to fill the soon to be vacant Undersecretary for Domestic Finance position. The current undersecretary, Jeffery Goldstein, announced on June 27th that he will be leaving the Treasury at the end of July. As mentioned above, Miller is currently the Treasury's point person on public debt management and is embroiled in the negotiations to raise the debt ceiling. In her new role, Miller will advise Secretary Geithner on banking, finance and regulatory policy in addition to working with the Financial Stability Oversight Council.

In addition to Miller's nomination, the Administration announced that Thomas Curry—currently a member of the FDIC board—will be the nominee for the empty Comptroller of the Currency position at the OCC. The nominations of Curry and Miller could signal that the Obama Administration will be addressing the problem of vacancies in the banking and finance regulatory regime more urgently in the coming months. However, the White House has yet to announce nominees to fill other prominent positions including the director of the CFPB, FHFA, and the White House Council of Economic Advisors.

DOJ

***Settlement between mortgage servicers and government on foreclosure continue to drag on*:** Once again, rumors circulated this week that mortgage servicers are close to reaching a settlement with federal and state officials on recent foreclosure controversies. Some news reports say a settlement could be reached in the next few weeks. According to sources close to the settlement talks, the amount of the settlement, originally pegged at $20 million, could reach as much as $60 billion to be split between two funds, one national fund and one fund to be split between individual states. The settlement would resolve the majority of federal foreclosure claims against Bank of America, JPMorgan, Wells Fargo, Citigroup and Ally Financial for robo-signing and other alleged crimes.

Republican members of the House Financial Services Committee were outspoken in their opposition to the settlement proceedings, as personified by Representative Randy Neugebauer (R-TX) saying that the "settlement proposal requires the resuscitation of policies and programs that have not worked or that Congress has explicitly rejected." Neugebauer is chairman of the Financial Services Oversight and Investigations Subcommittee and has also expressed concerns about CFPB's role in these negotiations, see more below on this topic.

FDIC

FDIC Adopts Claw Back Provisions for Executive Pay: On July 6 the FDIC board voted unanimously to adopt rules that allow the federal government to 'claw back' up to two years of compensation of executives who are found to be "substantially responsible" for the failure of a firm. The 'claw back' rules are part of the FDIC's new powers to undertake an orderly wind down of failing financial firms. The board also voted on final rules for Foreign Exchange (Forex) transactions and a proposed rule to calculate the "maximum obligation that the FDIC may incur in liquidating a systemically significant financial company." The FDIC said they will be acting jointly with the Fed on other provisions for orderly wind down in August—namely the 'living will' provisions of Dodd-Frank.

The adoption of the rules was one of the final actions of Sheila Bair as Chairman of the FDIC as her term expired on July 8th. Current Vice Chairman Martin J. Gruenberg will take over for Ms. Bair moving forward.

SEC

SEC admits errors with leasing deal and gives up leasing authority under pressure: On July 6th, SEC Chairman Mary Schapiro admitted that the Commission entered into a $550 million lease last year for space to house additional staff in anticipation of an appropriations bill which had not yet passed Congress. The bungled deal is being estimated to cost approximately $450,000 in renovation costs to taxpayers. Under pressure from all sides, the SEC has agreed to relinquish its leasing authority to the General Services Administration.

The news about SEC's bad deal has led to a broader scrutiny of agencies with leasing authority. Senators Tom Carper (D-DE) and Rob Portman (R-OH) both sent letters to the eight agencies with this authority requesting data on how they use property and details on the leases they have signed. With deficit negotiations scrutinizing all federal spending, the White House has released estimates that better leasing management could yield $15 billion in savings. To this end, Rep. Jeff Denham (R-CA) introduced legislation to create an independent board to give recommendations on what to sell, lease and consolidate.

CFTC

CFTC finalizes five Dodd-Frank rulemakings; defines agricultural commodity: On July 7, the CFTC approved five rules mandated by the Dodd-Frank Act including rules concerning: the definition of an agricultural commodity, business affiliate marketing and disposal of consumer information, privacy of consumer financial information, prohibitions on use of manipulative or deceptive devices and on price manipulation and greater trader reporting for physical commodity swaps.

The definition of the phrase 'agricultural commodity' is notable not only because it is the first time agricultural commodities have been defined by rule, but also because it defines the reach of Dodd-Frank agricultural swaps regulations. The new rule treats agricultural commodity swaps the same as swaps undertaken for any other commodity. The approval of the five rules underscores the increased pace at which the CFTC has been undertaking Dodd-Frank rulemaking—on which it is currently behind schedule.

Critics and proponents of derivatives reform trade barbs: On Thursday, the Progressive Policy Institute (PPI) released a position paper, arguing that job creation and the economy will suffer unless U.S. regulators are reined in from their far-reaching Dodd-Frank interpretations. Specifically, the organization asserted that Dodd-Frank derivatives reforms have the potential to harm traditional end-users, and Rep. Frank Lucas (R-OK), chair of the House Agriculture Committee, took the opportunity to criticize the administration for imposing new regulations that will only make the economy worse." On the other hand, supporters of derivatives reform countered that the positions made in the PPI paper have been "discredited" and can be "naively quoted in future lobbying work."

Efforts on international agreement regarding derivatives reform are also struggling to meet the self-imposed deadline of 2012 for implementing the G-20's transparency and risk reduction rules. International financial regulators are having trouble agreeing on certain details and timing of the agreed-upon rules, and global regulators and banks are concerned that the U.S. will withhold access to its markets unless international players comply with its rules. Global regulators again requested that the U.S. slow down in its rulemaking process. In response, CFTC Chairman Gary Gensler has stated that the U.S. is working "hand-in-hand with the Europeans, trying to get similar comprehensive and comparable rules." He also conceded that it would be easier if European rules were parallel to those already created in the United States.

CFTC hosts industry and staff roundtable on pending changes to proposed commodity pool operator rules: On Wednesday, the CFTC hosted a roundtable for financial industry representatives and agency staff to discuss the rules proposed in January that would change or rescind many exemptions that currently apply to commodity pool operators (CPOs) and commodity trading advisers (CTAs). Industry representatives expressed their concerns that removing these exemptions would be overly burdensome, with "little if any benefit to investors," and also argued that the 1940 Investment Company Act and related regulations are sufficient to police the industry. The proposed rules would specifically add new risk disclosure requirements for CPOs and CTAs regarding swap transactions, but also rescind registration exemptions and change the qualifications for claiming relief from CFTC regulation. Participants in the roundtable also made an oft-repeated plea for the CFTC and SEC to reconcile their disclosure and other mandates for dually-registered individuals and organizations.

***CFTC releases new data on energy price volatility*:** In reviewing the May 6, 2010 "flash crash" in which markets inexplicably plunged, the Commodity Futures Trading Commission released data earlier this week demonstrating that only 5.5% of crude oil futures trading on the New York Mercantile Exchange actually affect large traders' positions on price direction. In other words, nearly 95% of these trades are made by day traders or investors wagering on obscure price relationships, and therefore it is unlikely that long-term bets are affecting energy price volatility. This is particularly relevant, given the recent spike in oil prices, which reached their highest peak in 3 years. According to CFTC Chairman Gary Gensler, "the balance of trading is due to day trading or trading in calendar spreads." This new data still leaves room to question the impact of trading styles on prices, but will give economists food for thought as they analyze mysterious price ebbs and flows going forward.

CFPB

With Bureau set to go live in less than two weeks House Republicans redouble criticisms of mortgage servicing reform as CFPB readies to open: At a Financial Institutions and Oversight joint subcommittee hearing this week, House Republicans grilled financial services industry regulators about mortgage servicing reform and blasted the CFPB for its efforts to regulate the industry. Oversight Subcommittee Chairman Randy Neugebauer (R-TX) said that the "participation of political appointees, especially those affiliated with the CFPB —an agency with no regulatory or enforcement authority—raises serious concerns about the [mortgage servicer] settlement process."

However, when the CFPB officially opens its doors in less than two weeks, mortgage servicing reforms will be one of the first rulemakings according to the Bureau's associate director Raj Date. Date stressed that the Bureau has "rulemaking authorities under various federal laws relevant to mortgage servicing." Representative Barney Frank (D-MA) criticized Republican members for focusing their efforts on opposing the CFPB rather than focusing on how to fix the problems with the mortgage industry.

***FTC, Fed release final risk based pricing rule enforceable by the CFPB*:** On July 6th, the Federal Trade Commission (FTC) and Federal Reserve released the final changes to the risk based pricing rule which will require lenders to disclose credit score information to consumers when a credit score is used to set or adjust credit terms. The rule takes effect July 21st and will apply to depository institutions, credit unions and nonbank lenders such as mortgage companies, consumer lenders, utilities, auto dealers and other retailers.

The Consumer Financial Protection Bureau (CFPB) will be the agency responsible for implementing and enforcing the rule—even if there is not yet a confirmed Director at the time. As the CFPB begins to implement the risk based pricing rule, the Bureau will be required to undertake a study on the various credit scoring methods used by reporting agencies and evaluate their advantages and disadvantages to consumers. The Fed and FTC did not make changes to the language of the risk based pricing rule included in the Dodd-Frank Act because the CFPB "study may shed light on the extent to which disclosure of multiple credit scores would benefit consumers, and the Bureau could revisit the Agencies' judgment in view of the results of its study."

International News

EU Parliament takes preliminary steps to ban naked short selling of credit default swaps: On July 5th, the European Parliament approved legislative proposals that would ban naked short selling of

credit default swaps to back sovereign debt. The proposal is only a first step towards swaps regulation as the final legislation must be approved by all EU member states. Werner Langen, a German representative of Parliament, who played a large role in moving the legislation through Parliament, said he hopes that Parliament and member states will be able to reach agreement by September; however, only if there is "more determination on the part of the member states for real market transparency and a minimizing of risks associated with derivatives."

The goal of the legislation is to rein in the speculation on sovereign debt which played a role in the Greek debt crisis. In addition to banning naked short selling, the proposal would also drastically restrict naked short selling and create a new regulatory system on derivatives. The Parliament's proposal would require that all over-the-counter derivatives contracts be standardized and cleared by central clearing parties. However, while both the U.S. and the UK urged the European Parliament to incorporate exchanges and central clearing into the measure to create a level playing field and uniformity, neither provision is included.

Financial trade groups warn international regulators that greater harmonization is needed: On July 6th, eight U.S. and European financial trade associations sent a letter to European Commission Internal Markets and Services Commissioner Michel Barnier and U.S. Treasury Secretary Geithner, urging them to increase their cooperation to better harmonize derivatives market rules so as to avoid "damage" to markets. The letter said the possibility of two different regulatory regimes is a "fundamental concern" of the international finance community because derivatives counterparties are based in many different countries.

In addition to the arguments made concerning the harm to the derivatives market, the letter warned that disjointed rules could "lead to a more fragmented view of activity in financial markets, making it more difficult for regulators to monitor, much less prevent, a build-up of systemic risk." Harmonization of rules has been an ongoing concern for many market stakeholders and a continued talking point for international regulators; however, the trade groups that signed onto the letter implied that regulators are not doing enough to work together on these issues.

Upcoming Hearings

On Tuesday, July 12th at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing on enhanced investor protection after the financial crisis.

On Tuesday, July 12th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises will hold a mark-up of bills to overhaul and restructure the Government Sponsored Enterprises that are involved in the housing finance market.

On Tuesday, July 12th at 2:30pm, in 430 Dirksen, the Senate Health, Education, Labor and Pensions Committee will hold a hearing titled "The Power of Pensions: Building a Strong Middle Class and Strong Economy."

On Wednesday, July 13th at 9am, in HVC-210 Capitol Visitor Center, the House Ways and Means and Senate Finance Committees will hold a joint hearing on the taxation of debt and equity and the broader economic implications of this treatment.

On Wednesday, July 13th 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 "What Went Wrong at the Financial Crisis Inquiry Commission?"

On Wednesday, July 13th at 10am, in 210 Cannon, the House Budget Committee will hold a hearing titled "Medicare and Social Security: The Fiscal Facts."

On Wednesday, July 13th at 10am, in 2128 Rayburn, the House Financial Services Committee will convene to receive the semiannual Monetary Policy Report to the Congress from Federal Reserve Chairman Ben Bernanke.

On Wednesday, July 13th at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity will hold a hearing on mortgage origination issues.

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On Thursday, July 14th at 9am, in 2322 Rayburn, the House Energy and Commerce Subcommittee on Environment and the Economy will hold a hearing titled "Regulatory Chaos: Finding Legislative Solutions to Benefit Jobs and the Economy."

On Thursday, July 14th at 9:30am, in 2154 Rayburn, the House Oversight and Government Reform Committee will hold a hearing titled "Consumer Financial Protection Efforts: Answers Needed."

On Thursday, July 14th at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing to receive the semiannual Monetary Policy Report to Congress from the Federal Reserve System, with Chairman Ben Bernanke testifying.

On Thursday, July 14th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on the rent-to-own industry.

On Thursday, July 14th at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Oversight and Investigations will hold a hearing on the Office of Financial Research and the Financial Stability Oversight Council as data collectors and the potential for data security risks.