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FINANCIAL SERVICES LEGISLATIVE AND REGULATORY UPDATE

For the Week of August 1st, 2011

Although an 11th-hour agreement on the debt ceiling by the congressional leadership was reached, and the US was not forced to default, the collateral damage of this debate was evident late Friday evening when Standard & Poor's announced that it was downgrading the US credit rating from AAA to AA+. One reason S&P cited for the downgrade was the poisonous political environment in Washington, a factor that will weigh heavily on the "Super Committee" of 12 that was created by the debt ceiling agreement. With most of Congress fleeing town after voting on the debt deal, the majority of the week was spent doing post mortems on the deal, and speculation about who will be named to the committee. The announcement also came after a two week period where the markets had given back all of the gains made in 2011, having dropped 1,340 points since July 21st.

Please note that with Congress in recess this will be ML Strategies' last financial services policy update until September. In the event of any major news we will post it via our twitter account – @MLSFInRegUpdate. Also, this will be the last update co-authored by Cheryl Isaac Aaron, as she leaves us to go back to school for an LL.M. in securities and financial regulation at the Georgetown University Law Center. We have greatly enjoyed working with her, and while sad to see her depart, please join me in wishing her the best of luck on all of her future endeavors.

Leading the Week

Although Congress was able to get the deal done on the debt ceiling, the markets continued to react negatively, with the Dow Jones dropping 512 points on Thursday. Then, in the face of serious and significant opposition from the Treasury and others in the Administration, the S&P announced late Friday evening that it was downgrading the United States' credit rating. Because the other two rating agencies chose not to downgrade, it is unclear how much actual impact the S&P's decision will have, though the political impacts – on both parties – will be palatable. One factor in the S&P's decision-making was that the debt ceiling legislation does not actually deal with the U.S. debt problem, but instead empowers a new, congressional "super committee" – the Joint Select Committee on Deficit

Reduction – of 6 Republicans and 6 Democrats to flesh out the details of at least \$1.2 trillion in cuts over the course of the next decade. The same hot button issues on which the political parties could not agree prior to the legislation being enacted, such as tax reform and Medicare cuts, will likely continue to divide the super committee. However, as incentive for the parties to find common ground is the fact that creates a penalty for failure to cooperate or to win support from Congress: \$1.2 billion cuts would be made universally (without the committee's input) to all budget items, notably including defense and certain entitlement programs. However, what has not been widely reported is that the super committee can come up with less than \$1.2 trillion in cuts and then the automatic cuts (known as sequestration) would go into effect to make up the difference. As a result, it could be possible that certain areas of the budget actually receive more cuts than through the sequestration process alone.

With much of K Street getting to work to protect, or offer up cuts for the as of yet un-named members of the committee, there is rampant speculation that some type of tax reform will be included in the committee's recommendation. In fact, when signing the Budget Control Act of 2011 into law, President Obama called for a "balanced approach where everything is on the table," including reforming the tax code so that the biggest corporations and wealthiest individuals pay a fair amount. With members of both parties favoring some type of simplification of the tax code and for abolishing certain tax breaks, it appears that both parties will be under a significant amount of pressure to choose committee members who will stick to the party line, since the committee only requires a simple majority for passing the recommendations. Because of the strong likelihood that Republicans will not put someone on the committee who will "flip" and vote with Democrats, we don't not believe that comprehensive tax reform will ultimately be included in the Committee's recommendations, which are due by November 23rd, however, we anticipate "rifle shot" tweaks to the code to be included.

Overall, we believe the makeup of the super committee will be largely dispositive of successful budget and tax reforms – choosing members who are notorious for their unwillingness to compromise would dampen prospects from the get-go, and with some interest groups (health care in particular) already indicating that they may be better off with the automatic sequestrations, the chances for grid lock are increasing before the committee members are even named. Congressional leaders in both chambers and both parties will be making these determinations, and we are hearing that House Minority Leader Nancy Pelosi (D-CA) could name Reps. Chris Van Hollen (D-MD) and Jim Clyburn (D-SC) for two of the highly coveted spots. Her third pick could be won over by a Blue Dog, if the Coalition is successful in its lobbying efforts, though we suspect her preference would be to name another liberal Democrat, like Jan Schakowsky (D-IL) or Xavier Becerra (D-CA), a la the President's deficit commission of last year. Other names that are being floated include Sen. Max Baucus (D-MT), Sen. Kent Conrad (D-ND), Sen. Rob Portman (R-OH), Rep. Dave Camp (R-MI) and Rep. Paul Ryan (R-WI).

Congressional leaders have until August 16th to name members of the committee.

Legislative Branch

House of Representatives

Chairman Bachus announces plans to examine bill modernizing the SEC: On August 2nd, House Financial Services Committee Chairman Spencer Bachus (R-AL) said he is planning to take up legislation aimed at overhauling the SEC when the House comes back from recess in September.

Bachus said the goal of the legislation would be to improve the SEC's "operational inefficiencies," "strengthen ethical safeguards" and integrate better technology into agency offices.

The SEC Modernization Act would incorporate recommendations made by the SEC Inspector General, the Government Accountability Office and a private consultant's report mandated by the Dodd-Frank Act. In addition to addressing technological shortcomings and increasing ethical standards, the bill would also consolidate several SEC offices, including merging the Office of Compliance, Inspections and Examinations into the Divisions of Trading and Markets and Division of Investment Management.

Chairman Bachus stressed that the legislation should not be viewed as a censure of SEC Chairman Schapiro but rather necessary change to the dysfunctional "structure of the agency itself." As House and Senate Democrats continue to complain that Republican lawmakers are seeking to defang the SEC and the Dodd-Frank Act by not providing sufficient funding for the agency, this announcement may be seen as another attempt to circumvent the Dodd-Frank Act by changing the core responsibilities of the SEC.

Senate

House and Senate to remain in pro-forma session during August recess: Both the House of Representatives and Senate will be holding a series of *pro forma* sessions during the normal August recess in order to ensure that President Obama will be unable to make recess appointments. Notably, this means that the President will be unable to appoint Richard Cordray as CFPB Director. Without the possibility of a recess appointment, Cordray will have an uphill battle to confirmation with Senate Republicans vowing that they will not confirm a CFPB director until structural changes are made to the Bureau.

Senators formally request info on robo-signing incident from mortgage servicers: On Wednesday, Senators Patrick Leahy (D-VT) and Richard Blumenthal (D-CT) announced that they sent letters the previous week to 11 mortgage servicers requesting clarification on policies and procedures that affect mortgage foreclosures, filing proofs of claim and motions for relief from stay in bankruptcy courts. The two Senators, known for their consumer protection work, were intending to make certain the fair and honest treatment of homeowners in foreclosure proceedings. They cited a report by the Executive Office of the United States Trustee, which stated that the number of errors in bankruptcy court proofs of claim may in fact be significantly higher than initially reported. The Blumenthal/Leahy letter states that "defective or fraudulent filings, which have been far too common amidst the housing crisis, severely undermine the integrity of the Federal court system and greatly harm Americans navigating our Nation's current economic challenges."

In the meantime, everyone continues to wait for meaningful reforms by a coalition of state attorneys general, who are attempting to reach a settlement with mortgage servicers in light of the robo-signing scandal one year ago. Borrowers remain in the dark about bank decision-making in the foreclosure process, according to consumer advocacy groups, and little progress has been made in the numerous congressional hearings that have been held on the topic. The Senate Banking, Housing and Urban Affairs Committee even convened twice this week to consider "Housing Finance Reform: National Mortgage Servicing Standards" and "Examining the Housing Finance System: The To-Be-Announced Market." Notably, panelists expressed the urgency in fixing the housing finance system, and urged

Congress not to eliminate Fannie Mae and Freddie Mac altogether in order to keep borrowing costs from increasing.

Executive Branch

Treasury

Geithner pressured to remain at Treasury: As focus over the recent debt debate wanes, rumors that Secretary Geithner will be leaving the Treasury are reemerging. Despite Geithner stated that he has not determined whether to stay or go during an interview on Good Morning America on August 2nd, the New York Times reported on August 3rd that Geithner is expected to stay through President Obama's first term. According to officials close to the Treasury Secretary, Geithner has not yet notified the White House of his plans and the President and his Chief of Staff William Daley are actively trying to persuade Geithner to stay. Geithner's decision will likely be impactful next year with the 2012 election hinging on the economy and the near certainty of a difficult confirmation for his potential successor.

Obama debates need for downgrade by S&P: Prior to Standard & Poor's decision to down grade its credit rating decision for the United States, there was a pitched debate between Treasury and the S&P, with Treasury arguing that S&P made a \$2 trillion dollar basic math error. And while the two sides argued over base-line calculations and acceptable debt trajectories. Ultimately, despite any potential miscalculation or whether the proper frame is a five year or ten year outlook, S&P stuck with its decision due to the contentious political climate in Washington. In its statement announcing the downgrade the ratings company noted "The primary focus remained on the current level of debt, the trajectory of debt as a share of the economy, and the lack of apparent willingness of elected officials as a group to deal with the U.S. medium-term fiscal outlook," S&P said. "None of these key factors was meaningfully affected by the assumption revisions to the assumed growth of discretionary outlays and thus had no impact on the rating decision." It is worth noting, that the week before last, S&P President Deven Sharma testified before Congress that a hefty decrease in the U.S. deficit, along the lines of \$3-4 trillion, would be necessary for the country to avoid a downgrade. While Sharma tried to walk back that statement this past week, saying he was "misquoted," and the number used was merely based off of proposals put forward by legislators at the time, it does appear that the failure of the Congress and the White House to reach their "grand bargain" impacted the S&P's decision.

SEC

CFTC and SEC host industry roundtable on international swaps rules harmonization: On August 1st, swaps trading entities participating in a joint CFTC/SEC roundtable stressed to regulators that harmonization of rules—in terms of both intent and timing— with international regulators is crucial to ensure U.S. competitiveness. The participants, many of whom will likely be deemed swap dealers of major swap participants under the Dodd-Frank Act, said that if the U.S. acts too quickly they may lose business to other countries. Conversely, some participants argued that decisive action would give U.S. companies a head start as other countries follow suit. CFTC's Director of Clearing and Intermediary Oversight Ananda Radhakrishnan resisted the assertion that the U.S. should wait for international regulators to catch up. Radhakrishnan stressed that the current momentum for regulation will go away if the CFTC and SEC delay their rulemaking.

In addition to international harmonization, participants discussed end-user definitions and requirements. End-users at non-financial companies have long been concerned over their ability to use swaps to hedge commercial risk and requirements that swap dealers collect margin on end-user transactions. End-users at the roundtable stressed that a “significant conflict” would arise if the end-user exemption was not consistent across international jurisdictions.

CFTC

Senators urge CFTC to move forward with position limit rules for energy trades: On July 28th, four Senators—Richard Blumenthal (D-CT), Bill Nelson (D-FL), Ron Wyden (D-OR) and Bernie Sanders (I-VT)—sent a letter to the Commodity Futures Trading Commission requesting that the agency use the authority granted to them by the Dodd-Frank Act to begin imposing limits on energy trades. The letter said that rising energy prices, which could derail the economic recovery, necessitate spot-month position limits for exchange positions and swaps. The rationale behind the position limits is to “stop one investor from buying futures contracts in amounts that cause unwarranted price increases from excessive speculation.”

In the letter, senators also expressed disappointment that the CFTC had not yet tackled the position limit issue as the “statutory deadlines enacted in the Wall Street Reform and Consumer Protection Act have long since passed—more than six months ago.” The Dodd-Frank Act gave the Commission power to implement position limits ‘as necessary’—an extremely broad swath of power for the CFTC and one which should worry the industry, especially since these limits could impact trader’s ability to hedge against risk.

CFTC nominee Wetjen clears the Senate Agriculture Committee: On August 2nd, the Senate Agriculture Committee approved the nomination of Mark Wetjen for CFTC commissioner. Wetjen’s nomination was agreed to by voice vote. Despite hopes that the full Senate would take up the nomination later in the evening, the chamber recessed for the remainder of August before considering the nomination. Wetjen—currently a senior advisor to Senate Majority Leader Harry Reid (D-NV)—was nominated to replace Commissioner Mike Dunn. In the past, CFTC Chairman Gensler has been wary of taking up certain Dodd-Frank rulemakings because he lacks sufficient support to see them through, with Dunn’s vote tending to be in opposition. Thus, it is likely that Wetjen’s ultimate confirmation will be crucial to finalizing rulemakings and will therefore be opposed by Senate Republicans who have been adamant in their hostility to a number of financial regulatory nominees.

CFTC finalizes Dodd-Frank rules on whistle-blowing, SDRs and agricultural swaps: On Thursday, the CFTC voted to adopt its 9th, 10th and 11th Dodd-Frank rulemakings, with about three dozen more to go. One of the newly-adopted rules will create a system by which whistleblowers who share original information on illicit activities with the CFTC will receive a reward – between 10-30% of sanctions exceeding \$1 million. The agency will use its discretion in determining the exact amount of the bounty, taking into account the relevance of facts provided, the extent to which aid is provided and the extent of internal reporting by the whistleblower. The rule would also prohibit employer reprisal against the whistleblower.

The second rule adopted on Thursday would establish a procedure for the registration and operation of swap data repositories (SDRs), while also accounting for conflicts of interest, governance structure and antitrust concerns. The rule also bans the commercial use of data reported to the repositories, unless

agreed to by the submitter. Commissioner O'Malia expressed his concern that the issue of swap ownership remains uncertain because "between the swap counterparties, the swap execution facility, the derivatives clearing organization of the SDR, it remains unclear as to who owns and has rights to make commercial use of the actual data." The final rule adopted by the CFTC would permit the transaction of swaps with underlying agricultural commodities. These is an unprecedented derivative transactions, and therefore the agency went so far as defining these kinds of contracts, and clarifying that they will be treated the same as any other swap.

UPCOMING HEARINGS

The Senate and House of Representatives will both effectively be in recess until after Labor Day. Both chambers are staying in pro forma session so that President Obama cannot make any recess appointments. The following are the as of announced hearings for when Congress returns.

On Tuesday, September 6th at 2:30pm, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a confirmation hearing on the nomination of Richard Cordray, to be the first director of the Consumer Financial Protection Bureau.