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ML Strategies, LLC

701 Pennsylvania Avenue, N.W.
Washington, D.C. 20004 USA
202-434-7300
202-434-7400 fax
www.mlstrategies.com

Jason M. Rosenstock

Cheryl Isaac

Direct dial 202 434 7478
jrosenstock@mlstrategies.com

FINANCIAL SERVICES REGULATORY REFORM UPDATE WEEK OF APRIL 19TH 2010

REID SCHEDULES FIRST VOTE ON REGULATORY REFORM FOR MONDAY EVENING – IS THE TIME FOR TALKING REALLY OVER?

Baring any last minute resolution – and it should be noted that both Democratic and Republican Senate Banking Committee staffers were instructed to be in over the weekend -- it seems fairly certain that Monday evening's vote on the motion to proceed on consideration of the regulatory reform bill is going to fail. With folks on both sides of the aisle conceding that there will be Republican unity on the first procedural vote for regulatory reform, the real questions surround the Democratic strategy beyond that first vote, with some Republican aides conceding that rumors of GOP Senators who are not fully committed to taking multiple votes to continue the filibuster against reg reform are true. With this backdrop, it is conceivable the Democrats feel, having won with concessions on an exceedingly unpopular health care bill, that they can afford to press for a more "ideal" bill on regulatory reform because the populist opposition will not materialize. Under this scenario, it would seem that the outcome would be that the rumored possible deal announcement over the weekend will not materialize, and instead Democrats will move forward with a left-tilted bill, that may include other priorities of the left not directly related to curbing Wall Street's excesses, such as bankruptcy cram down, FTC reform, and interchange and Democrats will simply try to wear down Republican opposition with numerous cloture votes before needing to strike a real compromise.

Interestingly, part of the problem facing the GOP opposition is that despite the broad breadth of the legislation, they have not been able to attack this legislation in the same manner as they did with health care, and instead have been required to make more "silo-based" attacks on individual aspects of the bill, and spending considerable time in doing so. For example, for the better part of the last two weeks the Republicans actively voiced their opposition to the \$50 billion system risk resolution fund, claiming that the fund would only perpetuate, not prevent future bailouts. Whatever [the genesis of the repeated reference](#) to bailouts, by the end of the week the Republican's had succeeded in getting Chairman Dodd, Chairman Frank and the Secretary Geithner to admit their general agnosticism about the inclusion of the fund in the final bill. Despite this success, there are still a plethora of other concerns with the bill, (*e.g.*, the Volker rule; the over-the-counter derivatives bill, the consumer protection entity etc.) that there may not be enough time to apply this strategy to all of the issues that Republican's disagree with.

BANKS FACING INCREASINGLY UPHILL BATTLE ON THE VOLKER RULE

On Thursday, Senator Dodd announced that he felt that the language in the bill that prohibits “big” banks from engaging in proprietary trading for their own benefit, the so-called Volker Rule, was in a “pretty good place.” This is bad news for the banks, such as Goldman Sachs and others, who have taken advantage of the ability to engage in these transactions to make a considerable profit. Politically speaking, the biggest problem the banks have on this issue is that while they have personally objected to the language they have not been able to convince Republicans to make scaling back the language a top priority (as Republicans have instead focused on the Consumer Protection entity, derivatives and elimination of the \$50 billion dollar resolution trust fund).

Efforts to push the Volker rule received a significant boost on Thursday during the President’s speech at Cooper Union, where he specifically pitched the language, noting that it would “...not only safeguard our system against crises, [but] will also make our system stronger and more competitive by instilling confidence here at home and across the globe.” Additionally, the banks are facing efforts by other Senators who are looking to tighten the Dodd language. Finally, Senator Cantwell and McCain are expected to push for even tougher regulations, as they have announced their intention to introduce a floor amendment that would reinstate the Glass-Steagall restrictions imposed after the Great Depression.

AGRICULTURE COMMITTEE APPROVES DERIVATIVES MEASURE – TALKS CONTINUE AS BILL MOVES TO THE FLOOR

On Wednesday, by a vote of 13 – 8, with only Iowa Senator Chuck Grassley stepping across party lines, the Senate Agriculture Committee passed legislation to over hail the over-the-counter derivatives market. Although he voted against the measure, the top Republican on the committee, Saxby Chambliss of Georgia kept up the Republican desire not to be seen as the party of “no” by noting that “we agree on probably 90 percent of the issues that are out there.” However, he failed to mention that there were significant differences between the two sides on the remaining ten percent, with the most controversial provision being the proposal to force banks to spin-off or divest their derivatives trading desks. Republicans are not the only ones who have objections to the bill as passed, with Senator Tom Harkin (D-IA) expressing his displeasure with “last minute tweaks” to the bill that exempted commercial end users (i.e., companies that use derivatives to offset actual business costs such as fuel prices, or currency values) which he felt was too broadly worded. Additionally, Senator Conrad (D-ND) expressed concern that the bill as passed out of committee would impose significant up-front costs for farm credit banks that would negatively impact farmers. One group who was happy with the legislation was the motion picture industry, who had expressed concerns about a new venture by Media Derivatives Inc. and Cantor Futures that would have created a futures market for movie ticket sales, and was pleased that Lincoln’s bill narrowed the definition of “commodity” to prevent these types of “bets” from occurring. The legislation is expected to be integrated into Dodd’s larger regulatory reform measure.

SEC TO CONSIDER NEW DISCLOSURE RULES IN AFTERMATH OF
LEHMAN BROTHER'S "REPO 105" SCANDAL

In what may be the most far reaching regulatory change to come from the fallout of the collapse of Lehman Brothers, during a House Financial Services Committee hearing into the fall of the banking giant, SEC Chairwoman Mary Shapiro disclosed that the Commission is considering new rule that would prevent companies from masking the risk they take by temporarily lowering their debt levels in advance of their quarterly filings. What makes this disclosure so dramatic was the fact that SEC officials is considering this new rule to all publicly traded companies and not just financial firms.

This announcement follows on a story in the Wall Street Journal that noted that 18 large banks (including the brokerage units of J.P. Morgan Chase, Citigroup, Goldman Sachs, Morgan Stanley and Bank of America) had consistently lowered one type of debt, on average reducing it by 42% from quarterly peaks, at the end of each of the past five quarters, though it is already illegal to engage in this practice to intentionally deceive the public.

Among the changes being considered, include increasing the current rule that bank holding companies disclose their average debt balances in their annual reports to a quarterly obligation, as well as extending this requirement to all companies.

BANKS AND FINANCIAL INSTITUTIONS SLAM PROPOSED REFORMS TO BASEL II

The Basel Committee on Banking Supervision, the global body of banking regulators responsible for drawing up the Basel II accord, posted public comments on April 19 that had been submitted on its two draft proposals for strengthening the resilience of the banking sector and managing liquidity risks in response to the global financial crisis, which had been issued back in December. It appears that more than 250 public comments from banks, banking associations, investment houses, bonds and securities issuers, ratings agencies, financial economists, and other interested parties were received, with the overwhelming majority of them panning the draft proposals.

Criticisms were harshest from European institutions, which argued the proposals would have a bigger negative impact on them than their U.S. counterparts because of the difficulty in raising additional reserves through the European capital markets.

However, European companies were not the only ones to criticize the proposal. J.P. Morgan Chase tied its comments into the proposed regulatory reform being considered by Congress, noting that pending legislation along with the Basel II proposals would force financial institutions to significantly reduce the availability of credit. Morgan Stanley argued that the proposals as written "will likely make the financial system more fragile and further hamper an economic recovery."

Amongst the proposed policy suggestions included, stricter definition of Tier 1 capital, new capital buffers, a global leverage ratio, a new and strengthened definition of core capital, new standards for monitoring liquidity risk, and securitization and trading book charges. Although the proposals didn't specify specific numbers for either the leverage ratio or the core capital requirements critics

complained that these changes would drive the cost of capital up and that the increased bank lending spreads resulting from the proposals would probably lower economic growth for at least the first five years after the new rules are implemented.

While many criticized the proposed revisions to the definition of Tier I capital (a/k/a “quality capital”) because of the fact that the proposals knocked out many types of capital (including deferred tax assets, hybrid instruments, mortgage serving rights etc.) from the definition, the harshest complaints tended to focus on the Committee’s proposals on liquidity risk. Expectedly the American Securitization Forum (ASF) voiced the strongest opposition to these proposals noting they “could have a catastrophic effect on the short-term global capital markets.” ASF went on to say, “[t]his proposal—by requiring banks at all times to hold a stock of high quality liquid assets that equal or exceed their “net cash outflow” (calculated over a 30-day timeframe)—will significantly reduce (i) the amount of short-term funding that banks are able to provide to the credit markets and (ii) the amount of unfunded liquidity “backstop” facilities that banks may economically provide to corporations and other bank customers... and in fact, largely deprive banks of one of their most liquid and lowest cost sources of funds—the money markets.” Concluding that if adopted in their current form, the proposals would make it uneconomical for banks to issue any such short-term debt securities, either directly or through financing platforms, such as ABCP conduits or similar platforms that effect issuances of short-term tax exempt instruments.

The goal of Basel II is to have a full set of revised standards – with specific numbers and ratios – developed by the end of 2010 so that banks and other financial institutions can implement the new requirements by the end of 2012, a timeframe that was also roundly panned.

EUROPEAN INTERNAL MARKET COMMISSION OUTLINES “TOOL BOX” FUNDED BY TRANSACTION TAX TO ASSIST REGULATORS IN PREVENTING FUTURE ECONOMIC CRISES

Concerned that pending new European Union bank supervision plans and enhanced capital requirements will be insufficient to prevent and manage any future banking crisis like the one that has rocked the global economy over the past two years, European Internal Market Commissioner Michel Barnier presented an “integrated-crisis management” plan this week during informal meetings with EU Finance Ministers that were designed to make sure any future crisis does not come at the expense of taxpayers.

In order to be best equipped to deal with future crises, Barnier said the EU needed a common “tool box” that includes early intervention mechanisms as a well as resolution tools and all of them should be based on the “polluter pays principle”—a concept borrowed from environmental law that requires any company found guilty of causing ecological damage to pay for the clean up and restoration costs.

Noting that member states bailed out banks in the past year and a half in a wide variety of ways, Barnier seemed to be channeling congressional Democrats when he indicated that the EU’s first priority should be to establish a “coordinated resolution framework” that would include more harmonized preventive supervisory powers when it comes to corporate governance and risk management requirements. He also added, that the second part of this system should include early

intervention powers should allow authorities to force a bank to cease certain activities or limit profit dividends.

The plan, which would be triggered in the event that the prevention measures did not work, should also include a harmonized agreement on resolution tools that would allow for the imposition of “haircuts” on uninsured creditors and the transfer of assets and liabilities.

According to Barnier, this tool box would be funded through national resolution funds financed by banks via a bank levy or financial transaction tax, as he noted “these [funds] would support the cost of crisis management with robust burden-sharing arrangements for cross-border banking groups.”

It will be interesting to see whether or not this proposal moves, especially after similar transaction taxes were floated and deflated during Congress’ consideration of its regulatory reform. Were this proposal to move forward it would certainly counter arguments made against American reform efforts that the Administration’s efforts will effectively push money to London.

UPCOMING HEARINGS

On Wednesday, April 28th at 10am in Room 2128, the Subcommittee on Housing and Community Opportunity Subcommittee of the House Financial Service Committee will hold a hearing on Legislative Proposals to Preserve Public Housing. No witnesses have been announced yet.

On Wednesday, April 28th at 2pm in Room 2128, the International Monetary Policy and Trade Subcommittee of the House Financial Service Committee will hold a hearing on Promoting Small and Micro Enterprise in Haiti. Announced witnesses include, Mr. Simon Winter, Senior Vice President, Development, TechnoServe Inc; Mr. Mathias Pierre, GaMa Consulting s.a; Mr. Olivier Barrau, Managing Director, Alternative Insurance Company; Mr. David Roodman, Research Fellow, Center for Global Development; and Mr. John Sanbrailo, Executive Director, Pan American Development Foundation.

On Wednesday, April 28th at 2:00pm in Room 2220, the Subcommittee on Oversight and Investigations of the House Financial Services Committee will hold a hearing on Reviewing FinCEN Oversight Reports. Announced witness include, Mr. James H. Freis, Jr., Director, Financial Crimes Enforcement Network (FinCEN), U.S. Department of the Treasury; The Honorable Eric Thorson, Inspector General, U.S. Department of the Treasury; Mr. Richard J. Hillman, Managing Director, Financial Markets and Community Investment, Government Accountability Office (GAO); and Ms. Eileen Regen Larence, Director, Homeland Security and Justice Issues, Government Accountability Office (GAO).

On Thursday, April 29th at 10:00 am in Room 2128, the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Financial Services Committee will hold a hearing on Credit Default Swaps on Government Debt: Potential Implications of the Greek Debt Crisis. No witnesses announced at this time.