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FINANCIAL SERVICES REGULATORY REFORM UPDATE WEEK OF APRIL 26TH 2010

Third Times a Charm:

Financial Regulatory Reform moved forward in the Senate last week, officially by unanimous consent, but in reality there was nothing unanimous about it. Democrats were able to proceed as Republican's relented, and allowed the bill to come to the floor, claiming what may ultimately be a pyrrhic victory on eliminating the \$50b resolution trust fund. The first of what is anticipated to be around a hundred amendments to offered to the bill will be debated early this week, and while the first amendment, a non-controversial amendment offered by Senator Boxer to reinforce that no taxpayer money can be used for future bailouts, the rest of the amendments, including anticipated changes to the Bureau of Consumer Protection, the ability of banks to engage in proprietary trading, and reinstating the Glass-Steagall wall will certainly encounter significant opposition. Complicating the amendment strategy is uncertainty as to whether amendments will need to clear the difficult 60, or the easier 50 vote threshold for passage. The latest rumors were that a unanimous consent agreement might be offered to resolve this issue, but as of today it continues to remain unclear.

Although Chairman Dodd has indicated that he would like to wrap up this debate by mid-May, the timing for completion remains unclear. Further complicating efforts to determine when this bill gets to the President's desk is the fact that the House of Representatives, via both Financial Services Committee Chairman Frank and Speaker Pelosi, have strongly expressed their desire to see this legislation go to conference.

The Week Ahead:

With roughly 100 amendments anticipated to be offered to the legislation, Dodd and Shelby's staff worked through another weekend trying to find consensus to incorporate some of the proposals into a larger manager's amendment. However for some of these proposals, such as several that aim to set size limits on financial institutions or that allow regulators to order divestitures and breakups, they are likely to be driven by outside factors, as there seems to be a growing sense that the popular sentiment favors efforts to scale down or break up very large institutions. Amongst the stories driving this sentiment are the continued legal issues, including recent revelations of a Department of Justice inquiry, surrounding the banking giant Goldman Sachs, as well as the financial turmoil in Europe, where in addition to Greece, there are significant concerns about the financial stability of Spain and Portugal as well. Any chaos on the

European continent will be noticed by lawmakers already worried about risks to the financial system, and could provide additional ammunition to advocates of divestiture and breaking-up “big banks.”

After dealing with the Boxer amendment, the Senate will likely consider the manager’s amendment, which among other things will implement an accord between Dodd and Sen. Richard Shelby, the panel’s ranking member, on how to remove the \$50 billion resolution fund, with another apparatus for unwinding companies that are too tightly interwoven with the U.S. financial system to resolve through the normal bankruptcy process. This is a critical issue to the debate, not only because the fund had become a rallying cry for republicans, but also because without it the legislation is about \$17 million dollars short of being able to satisfy its pay-go obligations. Rumored to be included amongst the proposals to replace the fund are a fee on financial institutions could be substituted for the resolution fund, as well as several different approaches to a new assessment on financial institutions. Secretary Geithner is set to testify before the Senate Finance Committee on Tuesday, and both his response as well as the questions from the panel could provide insight into how these “bank taxes” will play out.

Other amendments likely to be offered is one by Sen. Kay Bailey Hutchison (R-Texas), who is reportedly considering offering an amendment to allow the Federal Reserve to maintain its supervisory authority over state banks not currently overseen by the Federal Deposit Insurance Corporation. As currently constituted, the Dodd bill would give the Fed regulatory authority over bank and thrift holding companies with more than \$50 billion in assets, while giving the FDIC oversight of all state banks and state bank holding companies with assets of \$50 billion or less. Additionally, the Office of the Comptroller of the Currency, which would absorb the soon to be defunct, Office of Thrift Supervision, would regulate all national banks and federal thrifts and their holding companies, as long as their assets do not exceed \$50 billion.

The Fed has sought to retain its authority over smaller state banks and their parent firms, saying it gives the central bank valuable insight into the broader U.S. economy.

Derivatives Continue to Drive Debate:

Last week much of the debate surrounding the bill focused on the Dodd-Lincoln amendment, which would set up a new regime to regulate the over the counter derivatives market. One of the more controversial components of the Dodd-Lincoln language is a requirement that big banks spin off their swaps desks, by effectively prohibiting them from receiving FDIC deposit insurance or accessing the Federal Reserve discount window in connection with their derivatives activities. This proposal, which could cost those companies as much as \$85 billion dollars, will face tough opposition, including from Democratic Senator Kristin Gellibrand, whose New York constituency is home to many of these swaps desks, and from the administration itself, as the Federal Reserve, in a rare and sharply worded memo, recommended outright that the provision be deleted. Republicans are also expected to offer amendments aimed at ensuring that non-financial companies, the so-called “end users”, are able to use derivatives without putting them

on the public exchange in order to hedge business risks associated with market fluctuations in their business.

Goldman Sachs testifies before Senate Committee:

On April 27th during a marathon session of the Senate Permanent Subcommittee on Investigations, former and current executives at Goldman Sachs Group Inc., acknowledged that the firm took short positions against the mortgage market and subprime loans underlying collateralized debt obligations in 2007, but denied that the move was either “directional” or contrary to the interests of its clients. Although this hearing received a tremendous amount of publicity, it was actually the fourth in a series of hearings based on the subcommittee's investigation into the causes of the financial crisis.

During the course of the hearing, it became clear that the panel's chairman, Sen. Carl Levin (D-Mich.) intended to demonstrate that because of lax regulatory oversight Goldman was able to reap substantial profits by selling and, simultaneously, betting against risky mortgage-backed securities. By questioning the ethics of an investment bank betting against the securities that it also sells, Levin was clearly laying the ground work to support an amendment to the Regulatory Reform bill that he is planning to offer that would restricting banks' ability to take short positions on the securities that they market to their clients.

This issue, which is essentially a reinstatement of the depression era Glass-Steagall wall, was met with skepticism by witnesses for Goldman, including David Viniar, executive vice president and chief financial officer at Goldman, who told the panel that reinstating Glass-Steagall would likely undermine the competitiveness of U.S. firms and make non-U.S. firms stronger, since no other jurisdiction is likely to adopt such a restriction.

The breadth of the hearing also implicated other components of the regulatory reform bill, as Sen. Susan Collins (R-Maine) contended that the potentially damning e-mails make the case for amending the federal securities laws to treat broker-dealers as fiduciaries, a proposal detested by the industry. . The idea was originally part of Dodd's draft bill to overhaul the financial regulatory system, however was subsequently watered down so that now the Securities and Exchange Commission study the matter before altering brokers' legal duties. However, Senator Menendez (D-NJ) plans on offering an amendment to reinstate the requirement, and it remains to be seen if the fallout from the Goldman hearing, and in particular the fairly unresponsive testimony of Daniel Sparks, head of Goldman's Mortgage Department from 2006 to 2008, about whether the firm, as a matter of policy, because of the lack of a legal duty, was able to put its interests before those of its clients, will generate public interest in this fairly complex change to securities law.

Dividend Taxes to Rise?

As passed by the Senate Budget Committee, it would appear that the tax rate on dividends will no longer be tied to capital gains rates after 2010, which raised questions among some lawmakers about whether Democrats intend to allow the top effective tax rate on dividends to

soar to more than 40 percent. Under the Jobs and Growth Tax Relief Reconciliation Act of 2003, the maximum dividend and capital gains tax rates have been linked together at 15 percent, however, that law is set to sunset soon, and unless Congress acts in the coming months, the capital gains tax rate will return to its pre-2003 level of 20 percent in 2011, with dividends being taxed at ordinary income tax rates of up to 39.6 percent. When combined with the 3.8 percent surtax created in the Health Care and Education Reconciliation Act of 2010, the effective top tax rate on dividends would rise to 43.4 percent in 2013.

Adding additional pressure to those interested in keeping these rates low is the fact that Congress is struggling to find acceptable offsets for other popular tax programs, and so finding \$100b to pay for these tax cuts, primarily seen to serve higher income voters, could be politically daunting. Senate Budget Committee Chairman Conrad said that the omission of language in the budget resolution was not intended to stake out a position on whether to let the dividends tax rate increase, rather he indicated that he wants to see the idea discussed as part of the National Commission on Fiscal Responsibility and Reform. That commission, which is comprised of several members of Congress, including Conrad and Gregg, and other White House appointees who have been tasked with finding ways to stabilize the long-term federal budget, held its first meeting early last week...Additionally, Senate Finance Committee Chairman Max Baucus (D-Mont.) echoed Conrad, by saying that no decision has been made on how proceed on dividend tax rates for high-income households. Baucus also suggested the budget resolution could still be changed to make room to keep the dividends tax rate tied to capital gains rates.

Upcoming Hearings:

With the Senate fully engaged in debating S., 3217, the Restoring American Financial Stability Act, there are no hearings currently scheduled in the Senate Banking Committee.

As of now, the only hearing in the House Financial Services Committee is a Subcommittee on Oversight and Investigations Hearing on The End of Excess (Part One): Revising Our Addiction to Debt and Leverage, which is scheduled for 10:00am on Thursday May, 6th in room 2128 of the Rayburn House Office Building.

On Tuesday, May 4th at 10:00 AM in room 215 Dirksen Senate Office Building, the Senate Finance Committee continues its examination of the President's Proposed Fee on Financial Institutions regarding TARP (a/k/a the Bank Tax). Scheduled to appear as witnesses are he Honorable Timothy Geithner, Secretary of the Treasury, United States Department of the Treasury, Steve Bartlett, President and CEO, Financial Services Roundtable, John K. Sorensen, President and CEO, Iowa Bankers Association, James Chesson, Chief Economist, American Bankers Association, and Patrick S. Baird, Chairman, AEGON, USA, LLC