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FINANCIAL SERVICES REGULATORY REFORM UPDATE

For the Week of May 17, 2010

REG REFORM PASSES THE SENATE:

Yesterday, the Senate passed its version of the regulatory reform bill (S. 3217), by a vote of 59-39, with four Republicans (Brown, Collins, Grassley and Snowe) voting in the affirmative and the same two Democrats (Cantwell and Feingold) joining the rest of the Republicans in voting against. The measure now turns to an anticipated House-Senate conference where it must be reconciled with the House-passed versions of regulatory reform (H.R 4173), passed in December without a single Republican vote.

Senate leadership had planned to consider a handful of amendments following the cloture vote, including an anticipated manager's amendment and two other controversial proposals (Brownback's amendment on auto dealers and the Levin-Merkley amendment banning depository institutions from proprietary trading) but instead opted to finish the bill promptly and push for changes during upcoming House-Senate conference negotiations. The informal, behind the scenes pre-conferencing that has been going on between House, Senate and White House staffers will be formalized early next week, with the Senate expected to announce its conferees on Monday, prior to a couple of controversial "motions to instruct." Because of the scope of the bill expect representatives from Banking, Agriculture, Appropriations and Commerce Committees. Although no names have been released, Senator Corker has been reported as saying that he expects a 7-5 party breakdown.

Upon leaving a meeting at the White House this morning, Dodd and Frank both indicated that it was their goal to get a final bill through both chambers and to the President before the July 4th recess. Despite claims that the bills are relatively similar, there are some substantial differences to bridge, one of which is the language dealing with derivatives language that will not be able to be touched until after the June 8th Arkansas run-off for the Democratic Primary. Further complicating the conference strategy is that opponents of the legislation are trying to determine how to enhance their leverage to negotiate while not being labeled a defender of Wall Street, while supporters of the measure are trying to finish up consideration to provide the markets with some much needed stability in terms of their future regulatory environment.

NOTABLE PROVISIONS IN THE SENATE BILL:

The Senate bill includes the establishment of a Consumer Financial Protection Bureau (CFPB), which will be housed at the Federal Reserve as a largely independent entity, though it is still unclear exactly how much authority the new bureau will have. Rep. Frank has stated his desire to ensure that the final reg reform package has a free-standing agency (the CFPB), reflecting the original Obama proposal. Additionally, the Senate bill also sets up a Financial Stability Oversight Council to monitor system risk, and gives federal authorities new tools to regulate financial companies and to shut them down as necessary, to prevent damage to the economy.

Although Senator Brownback pulled his amendment (excluding some auto dealers from regulation by the new Consumer Financial Protection Bureau) from consideration on Thursday, that language could still end up being included in the final reg reform package. Brownback decided to withdraw his measure to kill a Republican-opposed amendment by Senators Merkley and Levin, regarding proprietary trading. However, in lieu of voting on an amendment the Senate agreed to vote on a motion to instruct conferees that the official position of the Senate reflects the proposed Brownback amendment. This vote will take place on Monday evening, and with the White House actively working against the Brownback language it is expected to be close.

Additional last minute maneuverings included an amendment offered by Sen. Cornyn, which passed unanimously, and which would alter U.S. procedures with regard to the International Monetary Fund. This amendment would require the Administration to evaluate any proposed bailout of a foreign nation when that nation's public debt exceeds its annual gross domestic product, and then to certify to Congress whether the bailout loan will be repaid. If the administration cannot certify this repayment, then the U.S. executive director to the IMF would be required to oppose the bailout and vote against it. Cornyn's amendment came in response to the IMF's \$40 billion bailout of Greece on May 9th, of which approximately \$7 billion was attributed to U.S. contributions.

The Senate also approved a Rockefeller/Hutchison amendment that is intended to ensure that the FTC retains its core consumer protection functions. The amendment was approved by voice vote, and would mandate that the FTC and the proposed CFPB work together to ensure there are no gaps in regulation and enforcement with regard to financial products consumer protection. Interestingly, the House passed version of reg reform included significant enhancements to the FTC's power by eliminating the so-called Magnuson-Moss ("Mag-Moss") rulemaking standard, instead replacing it with the more expedient Administrative Procedure Act ("APA") rulemaking process. Although this issue hasn't received as much attention as some of the other differences between the House and Senate bills, if the House language survives, it would instantaneously have a major impact on numerous industries outside of the financial services world.

KEY DIFFERENCES BETWEEN THE SENATE AND THE HOUSE BILLS:

Perhaps the most notable disparity between the two reg reform bills is the inclusion of Senator Lincoln's derivatives language in the Senate-passed version. Lincoln's provision would essentially require banks to spin off their derivatives trading desks into separate companies, while the House bill

contains no like measure. Insiders expected Lincoln's derivatives provision to be killed at almost every stage in the proceeding (in Committee, by Dodd, after her primary, etc.), but to everyone's surprise and Wall Street's dismay, the language still survives, though the fact that she is involved in a run-off that will take place on June 8th may have something to do with that. It is quite possible these terms won't make it through conference, but given its endurance thus far, no one is willing to make any bets just yet. President Obama has also signaled his intention to take a strong role in developing the final bill, and he has made his opposition to the restrictive derivatives language clear. On the other hand, Rep. Frank has stated his willingness to include some of the Senate derivatives changes because they are more restrictive on big banks that dominate the OTC market.

If the derivatives language does remain in reg reform's final passage, insiders predict that there will be consequences for Democrats and President Obama's reelection, with regard to Wall Street support. Industry experts estimate that profits at major financial institutions could be cut as much as 20%, and that derivatives account for about half of all trading revenue at the biggest firms. Even if this language doesn't pass, some also say the damage is already done to Democrats, and previous supporters are weary of what they consider to be economically imprudent policy-making. The CEO of JP Morgan Chase, Jamie Dimon, made a rare public statement suggesting that the disorder in the Senate is adding to market volatility. He stressed that "global markets are in need of certainty."

The Senate bill contains a stricter rendering of the "Volcker Rule," which would prevent commercial banks from owning and investing in hedge funds and private equity, and limit the amount of trading they do for their own accounts, while the House contains no restraints on proprietary trading at all (in part because Volker publicly proposed after the House had passed its version of the bill. The Senate language would go even further than former Treasury Secretary Volcker's initial ideas, in that it would prohibit conflicts of interest by underwriters with respect to securities that are being sold, and would direct to SEC to issue rules along these lines. While Democrats will likely strongly push for this proprietary trading language, they may be limited if they want to maintain support from some Republicans.

Auditing the Federal Reserve is also a distinction between the two bills – the House allows for the GAO to audit emergency lending and some monetary policy decisions by the Fed, but the Senate bill would only allow an audit of the lending that occurred during the financial crisis, and not any prospective lending. The House also has a provision authorizing the government to force any bank to stop certain risky practices, or even divest certain operations, when the potential threat to the broader economy is sufficiently large. The Senate bill does not include this language at all, but would make it more difficult for big banks to grow, by setting new limits on the amount of liabilities they can control.

The House bill includes a \$150 billion fund, financed by a fee on large banks, to help pay for liquidation of failing financial companies. The Senate contains no like provision, and the Obama administration opposes this language, because it could purportedly hamper its ability to handle a more costly financial crisis.

The Senate bill has Senator Durbin's interchange provision that requires the Fed to reduce the fees that banks charge merchants to a "reasonable and proportionate" level for processing debit card transactions. Although the amendment exempts institutions with less than \$10 billion, the Independent

Community Bankers Association (“ICBA”) and the ABA both are opposed. The House bill contains no similar language, and there are rumors swirling that this provision will be part of a deal and dropped before final passage. That said, Durbin’s language has substantial political support and it would not be surprising if it survives the conference. However, critics pointed out that the day after this amendment passed the Senate, the top seven card-issuing U.S. commercial banks lost a combined \$21 billion in market capitalization.

Both bills allow for investors to sue credit rating agencies, if they “knowingly or recklessly” review key information in their ratings and violate securities laws. The Senate bill, though, goes further in giving the SEC power to establish a board that would assign an agency to rate a new issue of ABS’s, in the same way courts assign cases to judges.

Other provisions expected to be the subject of intense lobbying include how the final bill deals with the fiduciary duties imposed on broker dealers. While the House bill requires the SEC to impose a fiduciary standard similar to rules that apply to investment advisers, the Senate bill would require the SEC to study current standards and issue rules if it finds gaps or overlaps.

Additionally, the House bill would require hedge funds and private groups with more than \$150 million to register with the SEC, but it would exempt venture capital. Under the Senate bill hedge funds with more than \$100 million would be required to register with the SEC.

CONGRESS APPEARS SET TO ELIMINATE CARRIED INTEREST:

Although initial consideration was delayed, the House and Senate are expected to take up a jobs and tax package next week that among other things eliminates the so-called carried interest provision that has been used primarily by the real estate, private equity and venture capital industries. Eliminating these industries ability to use carried is reported to generate over \$18.7 billion for the government, and thus it has been used to offset the cost of extending many of the tax credits popular with businesses. Although some Senators,— Kerry, Shaheen and Cantwell and in particular — have been vocal in their opposition to eliminating carried because they see it a tax increase on venture capital firms that would stifle investment in a time when the economy is just starting to rebound, it is unlikely that the inclusion of the provision alone within a larger bill that includes job creating measures and the extension of popular tax credits will result in any Senator opposing the measure. The House is likely to consider the legislation on Tuesday or Wednesday and the Senate is anticipated to pass it by UC so that the President can sign it before Memorial Day.

WAYS AND MEANS COMMITTEE HOLDS HEARING ON INTERNET GAMBLING:

On Wednesday, the House Ways and Means Committee held a hearing on Internet Gambling, and how repealing the federal prohibition and the licensing and regulating the industry could generate substantial revenues for the federal government.

There are currently major two bills dealing with overturning the prohibition on Internet gambling, one authored by House Financial Services Chairman Barney Frank (H.R. 2267), would creates a full licensing and regulatory framework for the Internet gambling industry in the United States, and the other, a bill authored by Rep. Jim McDermott (H.R. 4976) is the companion tax bill to the licensing

regime. It is estimated that regulating and taxing Internet gaming would raise about \$42 billion in tax revenue, most of which would come from income taxes collected on individuals' winnings. As currently structured, Rep. McDermott's bill would also impose an 8% tax on online gambling deposits, to be paid for by the operators of gaming websites. Of that total 8%, the federal licensing fee would constitute 2% of deposits and the remaining 6% tax on deposits would benefit state and tribal governments. Although the bills would legalize and regulate online poker, a ban on some other forms of online gambling, including betting on professional sports, would continue. As a potential sweetener McDermott's legislation dictates that 25% of the tax revenues received from online gambling will be directed to the Transitional Assistance Trust Fund, which provides educational opportunities and job training for those currently or formerly in foster care. Additionally, another half a percent of the funds raised through the legislation would be distributed to the American Heritage Block Grant Fund, for the benefit of the arts and historic preservation.

Supporters of the bills say despite the 2006 law, Americans are still gambling online. They point to estimates that this year, \$12 billion has been deposited in offshore online gambling accounts, while offshore gambling operators have received about \$5 billion a year in gross revenues. Despite the rosy revenue scenarios, there is significant opposition, within both parties, to overturning the federal prohibition, and a major test on this issue will occur later this summer when Frank brings his bill up for a vote in his committee.

UPCOMING HEARINGS

On Tuesday, May 25th at 10am, in 215 Dirksen, the Senate Committee on Finance will hold a hearing entitled "Reducing Overpayments and Increasing Quality in the Unemployment System."

On Tuesday, May 25th at 10am, in 2128 Rayburn, the House Committee on Financial Services will hold a hearing on "The Administration's Proposal to Preserve and Transform Public and Assisted Housing: The Transforming Rental Assistance Initiative."

On Tuesday, May 25th at 10:30am, in 210 Cannon, the Joint Economic Committee will hold a hearing entitled "Avoiding a Lost Generation: How to Minimize the Impact of the Great Recession on Young Workers."

On Tuesday, May 25th at 11am, in 2141 Rayburn, the House Judiciary Committee's Subcommittee on Commercial and Administrative Law will hold a hearing on "Protecting Employees and Retirees in Business Bankruptcies Act of 2010."

On Wednesday, May 26th at 10am, in 2128 Rayburn, the House Committee on Financial Services' Subcommittee on Oversight and Investigations will hold a hearing on "Anti-Money Laundering: Blocking Terrorist Financing and its Impact on Lawful Charities."

On Wednesday, May 26th at 2pm, in 2128 Rayburn, the House Committee on Financial Services' Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will hold a hearing entitled "FHFA Oversight: Current State of the Housing Government Sponsored Enterprises."