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FINANCIAL SERVICES REGULATORY REFORM UPDATE

For the Week of May 31, 2010

CONGRESSIONAL RECESS - THE QUIET BEFORE THE STORM:

With both houses of Congress out of session due to the Memorial Day Recess, most of the work being done in preparation of the final sprint toward culmination of a two year process of Regulatory Reform happened behind the scenes, as both the Administration and some lawmakers took advantage of this week's recess to make public statements and push controversial provisions behind the scenes. The public continues to await the House conferee selection, although Rep. Frank has already stated his preference for all the relevant subcommittee chairs plus Rep. Maloney (a former subcommittee chair), we are hearing that he will only get five financial services committee members onto the conference, which would necessitate the dropping of two from his original list.

The Financial Crisis Inquiry Commission took advantage of a slow week on the Hill to ask some hard questions of the former heads of one of the major credit rating agencies, though many perceived the outcome as unsatisfactory with the current Moody's CEO defending his firm's actions.

The international community is also gearing up for its own watered-down financial regulatory reform, with G20 meetings kicking off in South Korea and discussions starting up on the Basel Committee on Banking Supervision.

THE LEAD-UP TO THE HOUSE-SENATE CONFERENCE

This past week, Senator Franken and Rep. Sherman urged conferees to include the Franken-introduced amendment that would authorize the SEC to create an investor-led board to select firms to make ratings on a rotating basis. Franken confidently stated that the provision addresses the credit rating problem in the industry, and that those terms will make it to the President's desk. However, two conferees (Senators Dodd and Reed, who wrote the Senate section on credit-ratings regulation) voted against the Franken amendment when it was on the Senate floor, and a third conferee (House Financial Services Chair Frank) called for further study during a mark-up on the issue last year.

Expectedly, the two major credit rating firms – Standard & Poor's and Moody's Investors Service – strongly oppose the amendment because it would force them to lose some of their market share. The director of corporate communications for S&P defended his firm's stance by stating that the Franken amendment would remove the incentive for credit rating firms to compete with one another, pursue

innovation, and improve their models, criteria and methodologies. He stated that adopting the new terms could lead to more homogenized rating opinions and deprive investors of “valuable, differentiated opinions on credit risk.”

Both the Senate and House bills already impose lower liability standards on rating agencies, by allowing investors to sue if the firm “knowingly or recklessly” reviews key information in their ratings. Franken’s language surprised some industry members in how strict it is, but some supporters have stated that it could go even further in applying to more transactions than structured finance, corporate and municipal debt.

Senators Levin’s and Merkley’s “Volcker Rule plus” amendment got a lot of press this week, especially as a potential replacement for Senator Lincoln’s stricter and more controversial swap desk spin-off amendment. Lincoln’s amendment is publicly opposed by the Fed, the FDIC and the banking industry, however most have treaded carefully around the issue in advance of Senator Lincoln’s run-off primary election on Tuesday, June 8th. In addition to banning proprietary trading, the Levin-Merkley amendment would add a new conflict of interest rule to stop banks from taking a contrary position in the market to a client, with exceptions for market making and hedging.

Wall Street analysts are predicting the Levin-Merkley ban on proprietary trading to be much less damaging to revenue and profits than the Lincoln language. Even though the former amendment is a strict ban, there is still considered to be some “wiggle room” in what constitutes proprietary trading, and how the regulators actually implement the rule after they study it. For instance, if the ban only applies to trading done exclusively with a bank’s own capital for its own account, it would be a nominal cut in profits for banks like Goldman Sachs and Morgan Stanley. Even if the ban is much stricter, the two banks always have the option of giving up their bank holding company status in order to not be subject to the new restrictions.

The Independent Community Bankers of America (ICBA) expressed its concern with the Collins amendment, which would restrict the inclusion of trust-preferred securities in Tier 1 capital (with regard to capital ratio requirements). Trust-preferred securities are hybrid entities with both debt and equity characteristics. The ICBA asked Senate conferees to reduce new limits on capital under the measure because of a potential for ensuing bank failures and a credit crunch. Community banks, the organization said, cannot easily tap into capital markets like their larger competitors, and rely heavily on these securities. The organization stated its concern that changing the rules would cause these banks to reduce their lending in order to maintain capital ratios, which would remove much-needed credit from the recovering economy.

The Collins amendment is expected to receive a significant amount of attention during the House-Senate conference next week, but its inclusion in the final bill is uncertain. Although FDIC Chair Bair is a supporter, many predict that the provision will be stricken entirely, or at the very least severely modified.

On Wednesday, the Financial Crisis Inquiry Commission, a bipartisan organization established by Congress, convened in New York City to examine the role of credit rating agencies in the financial crisis. Present at the special congressional panel were former executives of Moody's, plus Warren Buffett, whose company Berkshire Hathaway owns a 13% stake in Moody's. Buffett refused to testify voluntarily, and thus was subpoenaed to appear before the Commission.

In Buffett's testimony, he stated that he did not in fact know that much about the credit rating market, and had never even been to Moody's. He also defended the company in saying that it "made a mistake that virtually everybody in the country made." His explanation for owning so much stock in the company was that he believes in its overarching business model.

The former managing director of Moody's derivatives team, Eric Kolchinsky, bluntly testified that market share became more important to Moody's senior management than the quality of its ratings. He also stated that the culture at his firm changed dramatically by 2007, which his division's revenues making up 20% of the entire firm's revenue. During his tenure, he only rejected one deal, and that bank went to two other agencies who then gave the securities AAA ratings.

Another former executive, Mark Froeba, in his written testimony said that Moody's "simply abandoned its analytical distinctiveness" and that its executives encouraged outside bankers to bully analysts into giving them the ratings they wanted for their structured products. Other critics also said that the firm relaxed its methodologies, sometimes after pressure from investment banks paying for the ratings, to boost short-term profits at the expense of accuracy and a risk to its long-term reputation.

The current CEO of Moody's, Raymond W. McDaniel, was quick to defend his firm. Although McDaniel expressed disappointment with the inaccurate ratings that his firm had given out, he endorsed the methodologies, ethics and natures of Moody's ratings on the whole.

OBAMA CALLS FOR END TO OIL TAX BREAKS

In a speech at Carnegie Mellon University on Wednesday, President Obama called for the U.S.'s accelerated transition to clean energy. He stated his support for an end to the tax breaks from which oil companies currently benefit, even though he also believes oil exploration will still be necessary. Although Obama does not think he has enough vote to pass an energy and climate bill, he asserted that he would find the votes and "finally [put] a price on carbon pollution." By revoking billions of dollars in tax breaks to oil companies, he plans on making investments in clean energy research and development a priority.

GROUP OF 20 MEETS IN SOUTH KOREA

The G20 nations (the world's systemically important wealthy economies and emerging markets) met in Busan, South Korea on Thursday to discuss international monetary and fiscal policy, with a focus on reducing budget deficits and restoring balance to the global economy. Finance ministers were also expected to discuss the medium-term growth framework. It is unlikely that any consensus will be reached on financial and regulatory reform, but Treasury Secretary Timothy Geithner stated that finding the right balance between growth and budget restraint was a "shared imperative" of the G20 nations. Britain's

finance minister, George Osborne, also stated that struggling countries need to ensure that they can handle their deficits, while flush countries need to ensure that they play their part in contributing to the global economy.

The Canadian finance minister, Jim Flaherty, and others also discussed the need to move forward with exit strategies. Most of the G20 countries have acknowledged the concept of unwinding the policies they enacted to deal with the financial crisis, but so far only Canada has gone so far as to raise its key interest rate. Flaherty also stated Canada's opposition to the idea of an international bank levy to pay for a future financial bailout, which has been floated by some of his counterparts.

The EU financial crisis is expected to be a large topic of conversation by the G20, and the Chinese Vice Premier, Wang Qishan, already stated his concern that the G20 has not acted more decisively. Germany, one of the more financially stable EU states, is preparing to make budget cuts and the French finance minister, Christine Lagarde, spoke in defense of her German counterpart stating that this was a matter of "fine-tuning." Germany is also considering raising its value-added tax to the full 19% rate on certain items that are currently set to the 7% rate. The G20 will be meeting again in July in Toronto, and then in Seoul in November.

EUROPEAN COMMISSION MAKES STRICT REFORM RECOMMENDATIONS

In response to the new regulations the EU is in the process of adopting, the European Commission (EC) put out a "green paper" calling for stricter corporate governance and enhanced shareholder rights. A green paper is the step prior to making a formal legislative proposal. The EC's recommendations included limited board membership for individuals, compensation restrictions, expertise requirements and supervision powers to review corporate governance structures.

The EC stated that its corporate governance recommendations are in step with the Basel Committee on Banking Supervision's proposals, but that its shareholder and auditing advisements went further. Corporate governance rules vary widely between the 27 EU member states, as a result of the diverse corporate cultures. As a result, the EC's suggestions in this area have been regularly ignored. The EC will have a "consultation period" until September, in order to obtain feedback on its recommendations.

UPCOMING HEARINGS

On Wednesday, June 9th at 10am, in 2359 Rayburn, the Financial Services and General Government Subcommittee of the House Appropriations Committee will hold hearings on proposed fiscal 2011 appropriations for programs and activities under its jurisdiction.

On Wednesday, June 9th at 10am, in 210 Cannon, the House Budget Committee will hold a hearing entitled "State of the Economy: View from the Federal Reserve."