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Financial Services Regulatory Reform Update

For the Week of June 14, 2010

THE REG REFORM CONFERENCE COMPLETES ITS FIRST WEEK

Even though Chairman Frank has pledged to have the most transparent conference, with the entire proceeding being broadcast on C-SPAN, committee leaders and staff are expected to work through the weekend on the laundry list of contentious issues still to come, as timing remains an issue, if the conference is to meet President Obama's requested June 26th goal for completing work on the conference.

Although this past week dealt with some fairly controversial issues, generally speaking this past week involved consideration of the proverbial "low hanging fruit" with the most contentions provisions, including derivatives, the Volcker Rule, the consumer protection entity, swipe fees and final work on the Collins capital requirements provision due up this week. While the White House is expected to weigh in heavily on all of these matters, and in fact top Democrats, including White House Chief of Staff Rahm Emanuel, Treasury Secretary Timothy Geithner, Conference Committee Chairman Frank, and Senate Banking Committee Chairman Dodd and others met behind closed doors on Thursday night to "strategize about common goals," and not to make any back-room deals, according to Frank, the ultimate deciding factor may come down to whether Chairman Dodd thinks he can get 60 votes on the issue in the Senate.

AS THE CONFERNECE CONTINUES THE PROCESS IS MODIFIED

Although on the first day the conferees went back and forth a couple of time (i.e., a House offer, a senate counter offer, a House counter to the Senate's counter, etc.) on the first day of the conference, due to concerns about members of the conference intentionally delaying the process and in an effort to be more efficient with timing so as to meet the President's goal of concluding the conference before he heads to the G20 in on June 26th , Chairman Frank instituted a new process on Wednesday. Now, the House will debate its own offer, which it will then present to the Senate. The Senate will then counter, and then the House can accept or reject that offer (in whole or in part). Any final differences between the two chambers will be set aside for the final day of the conference, when they will be fully negotiated and finalized.

In other conferences and up until the first day of this forum, the traditional process was for the House to put out an offer, on which the House conferees would then debate before bringing it to the Senate.

PROGRESS MADE: AGREED-UPON PROVISIONS

Although there was confusion on the first day as to how to file amendments and run the conference process, the melding of the House and Senate bills got off to a good start last week as the conferees agreeing to merge the Office of Thrift Supervision into the Office of the Comptroller of the Currency. Senate conferees also agreed to a key House provision that would exempt small issuers (less than $75 million in market capitalization) from being subject to the Section 404(b) requirements in Sarbanes-Oxley. The House reciprocated by agreeing with the Senate on granting self-funding to the SEC. Initially, the House bill had authorized more funding for the SEC, but self-funding is now likely to end up in the final version of the bill.

House and Senate conferees reached an agreement on granting authority to the Government Accountability Office (GAO) to audit the Federal Reserve. The committee went with the stricter House language, that would allow the GAO to regularly audit discount window lending and open market transactions, in addition to emergency lending programs. Two years after the Fed initiates open market or discount window transactions, it would be required to disclose the borrowers and details to the GAO.

The conferees also reached agreement on a House proposal, regarding the election of the twelve regional Fed presidents. The agreed-upon provision would bar member bank representatives on each regional board from voting or appointing the president of a Reserve Bank. Instead, six non-banker directors sitting on regional Fed boards would make the selection, so that there is less potential for a conflict of interest. The Senate conferees also voted to drop the Senate language that would have made the New York Fed president post a White House appointee subject to Senate confirmation.

The House and Senate conferees agreed to strip conflict of interest rules for credit rating agencies out of the final bill. Although Sen. Franken's initial proposal was met with broad bipartisan support in the Senate, key players including Dodd and Frank opposed the idea because of the practical difficulties in the plan of making random assignments to rating agencies. Senate Democrats said they would be willing to remove Franken's language and replace it with Frank's proposal calling for the SEC to study the conflict of interest issue, and eventually impose new rules in this realm. On Wednesday, conferees agreed to take the House language that would require rating agencies to comply with existing rules requiring companies to disclose material non-public information. Conferees also accepted Senate language that would apply a "knowing and reckless" standard to credit rating agencies that violate anti-fraud provisions of securities law, as opposed to the "grossly negligent" standard proposed by the House.

THE WEEK AHEAD – CONFEREES TO TACKE THE MOST CONTENTIOUS PROVISIONS

Sen. Lincoln's derivatives spin-off provision is still up for debate, though Chairman Frank stated this week that the derivatives section of the bill will remain and he thinks "we're very close now to an agreement." He added that Lincoln's provision is right in principle, but there were some technical issues that had to be straightened out. Others also reported that the conference committee is "near consensus." The deal would require banks to spin their swaps desks off into separate affiliates, which would also necessitate that the banks raise new capital and deprive them of a significant amount of

profit. The latest statement of outrage came from a large group of mid-size regional banks (including PNC, SunTrust and BB&T), who sent a letter to conference leaders arguing that Lincoln's derivatives measure will have a negative impact on "small and mid-sized companies, local and state governments, schools, hospitals, community and regional banks, and commercial real estate developers."

Lincoln sent out a memorandum last Monday clarifying the controversial spin-off provision in her proposed language. She stated that this measure would not force bank holding companies to completely divest their derivatives operations, but would rather allow these companies to retain the operations so long as they were separately capitalized and subject to certain Federal Reserve Act restrictions.

43 members of the New Democrat Coalition (moderate House legislators) wrote a letter to conference leaders on Wednesday, calling on them to include broad exemptions for end users from mandatory derivatives clearing and exchange-trading requirements in the final reg reform package. The Senate bill is narrower in its exemption for commercial, non-financial interests, while the House bill would exempt swap dealers and other financial companies. The Coalition posited in its letter that other reg reform protections, including adequate capital reserves, are sufficient to guard against risk.

The Volcker Rule, which has not yet been formally debated in conference, is potentially going to be subject to a significant weakening, if four House conferees have their way. Reps. Moore, Meeks, Watt and Gutierrez (all Democrats) are private pushing to write a loophole into the Volcker Rule that would allow banks to invest in hedge and private equity funds. Industry members predictably support this loophole, but former Treasury Secretary Volcker himself adamantly opposes it. Volcker was supposed to meet with key Democrats yesterday, to warm them against supporting this new provision, but the meeting was canceled at the last minute. Republicans are also toying with the idea of allowing banks to invest 5% of their capital in hedge funds. Sen. Scott Brown reportedly likes the loophole idea, and as a potential "60th vote," his opinion on what goes in the final bill can carry a substantial amount of weight.

Although community banks, credit unions and state officials are all campaigning against the Senate-passed interchange fee amendment is looking more and more likely to end up in the final reg reform bill. Chairman Frank has stated his support for the provision, though earlier in the process he had claimed that it would likely see no action in 2010. Sen. Durbin's interchange amendment would authorize the Federal Reserve to ensure that debit card fees are "reasonable and proportional" in relation to processing costs. The American Bankers Association criticizes the amendment because it precludes the Fed from considering certain costs, such as infrastructure expenses and account management expenses, which are "very real and significant costs banks incur in making debit cards available to their customers." The industry also argues that the provisions exempting community banks and credit unions with assets below $10 billion are essentially meaningless, as represented by a letter from the National Association of Federal Credit Unions to the conference committee.

The conference still has a ways to go in determining how to handle systemic risk, and an early draft of a Senate counteroffer (not yet sent to the House) confirms this. The conference base text would create a Financial Services Oversight Council to identify and respond to emerging risks to the financial

system, and with the authority to create tough restrictions on potentially threatening companies. The House language would allow the council to impose capital and leverage requirements on financial institutions based on the types of activities they are involved in and how the institution's failure would impact the economy. Firms that are deemed risky would be prohibited from having a debt-to-equity ratio of greater than 15-1. Explicit language would clarify that these requirements would not be based solely on the size of the firm.

The House conferees formally decided to offer new language clarifying that various financial instruments that now count toward regulatory capital requirements would continue to do so going forward. Specifically the amendment would broadly grandfather trust-preferred securities and other capital components for the duration of those instruments, without regard to asset size. The language was offered by Reps. Moore and Peters, and garnered broad bipartisan support. Sen. Collins' language, which the Senate approved in its initially bill, would ban banks and bank holding companies from including commonly held "trust preferred" securities as part of their capital requirements. FDIC Chair Sheila Bair backs the Collins measure, and has stated that banks need more capital to weather crises like that of 2008. The Treasury and Fed do not support the stricter capital requirements because they will make it more difficult for U.S. negotiators to create new global capital rules that are to be determined by the end of the year.

Leftover from last's week debate on the investor protections section of the legislation, the conference is expected to take up a proposal offered by Dodd that would limit proxy access to those holding at least 5% of a company's shares for at least two years. This comes after Dodd, Lincoln and Johnson all voted with the Republicans to defeat an amendment offered by Schumer to strip all limits on proxy access. It is unclear whether this language or some compromise will remain in the final legislation, as Republicans are unilaterally opposed to proxy access, and House Democrats have stated that they feel strongly about not diluting the proxy access provisions. The conference committee will also be making a determination on executive compensation - the House bill would allow regulators, including the SEC, to prohibit risky pay schemes for executives and other employees at financial institutions, while the Senate bill would take a narrower approach of empowering banking regulators to curb pay at depository institutions.

The conferees have yet to sign off on the Consumer Financial Protection Bureau, but will likely do so next week. The new regulatory agency would have independent rule-making authority, the freedom to set its own budget and consume up to 12% of the earnings of the Federal Reserve System, and vast jurisdiction over almost all issuers of consumer financial products (including those distributed by non-bank financial services companies). The agency will determine whether certain fees and almost all financial services and products outside the securities and insurance industries are "unfair, deceptive, or abusive." Although significant media attention is likely to focus on the so-called "auto dealer exemption," the most systemically impacting issue in this section of the bill, one that is flying beneath the radar, is whether House Energy and Commerce Chairman Henry Waxman will succeed in changing how the Federal Trade Commission (FTC) conducts its business. Currently the FTC operates under a more restrictive procedural process known as "Mag –Moss," however Waxman is looking to vest with the FTC with a looser, quicker and ultimately more deferential process known as Administrative Procedure Act, or APA, rulemaking. It is not known if Waxman can muster enough

support in the conference for his proposal, but since it isn't one of the top issues generating attention, there is a decent chance that the measure could slide in the final package.

CONSIDERTION OF THE "TAX EXTENDERS BILL DRAGS ON – CARRIED INTEREST PROVISIONS CONTINUE TO CHANGE

The Senate is continuing its debate on H.R. 4213, the American Jobs and Closing Tax Loopholes Act of 2010, after a second failed cloture vote on the Baucus amendment on Thursday. The "extenders bill," as it is called, would extend unemployment insurance and some beneficial tax treatment, in addition to increasing federal matching for state Medicaid payments, and other changes. The Baucus amendment would have decreased the overall price tag on the bill from$140 billion to $118 billion. Senators Lieberman (I-CT) and Nelson (D-NE) voted with Republicans against the "motion to invoke cloture on the motion to concur in the House amendment to the Senate amendment to H.R. 4213, with the updated Baucus amendment." The Senate Democrats are four votes shy of the 60 that are needed to end debate on the bill, which is being hotly contested because of its cost.

Senate Minority Leader McConnell stated that Senate leaders will work together this weekend to find more common ground, and more amendments could be introduced during the coming week. His colleague, Sen. Thune, had offered an amendment that would have replaced all the tax increases in the Democrat's extenders will with spending cuts or unspent stimulus dollars. Thune's amendment failed, with only 41 voting in favor.

Baucus remained optimistic that the Senate could garner the 60 votes it needs to end debate, though he wasn't sure when this would happen. He also spoke about the bill's controversial carried interest provisions, and specifically a subsection of that issue that deal with how founders of partnerships will pay taxes at ordinary rates on 50% of proceeds from sales of their firm's shares. This language was modified from a previous Senate version of this amendment in order to address an oversight in drafting, and to handle situations in which partnership owners would pay taxes on the enterprise value (the increase in the value of a business's stock as a result of returns from the owners' years of building the company) of their holdings.

SEC CIRCUIT BREAKERS TAKEN FOR TEST DRIVE

Shortly after the SEC approved a pilot program for "circuit breakers," the new system was put to use when the Washington Post Co.'s shares went up 99% in less than one second on Thursday. Trading on the Washington Post's stock halted for five minutes, and may have prevented erratic trading. As a result of the inexplicable May 6th market dip, the SEC began this program last week to slow down trading when faulty data or panic is potentially influencing the market, causing any individual stock to rise or fall more than 10% in five minutes or less.

Although the circuit breakers addressed the symptoms of market volatility, some experts are still uneasy that the underlying problems behind the May 6th plunge and Washington Post erratic trading could happen again. On June 2nd, Diebold stock erased 30% of its market value in 6 seconds, and this is currently under review by U.S. regulators. As Sen. Kaufman noted, this is a problem because it causes people to lose trust in the markets, which need to have credibility. The SEC is also considering

other measures, including pricing collars, which would prevent market orders from trading at a price more than 50 cents or 5% worse than the best available ask.

Kaufman also made a statement that the SEC should consider whether to regulate trading speeds and discourage the diversion of order flow from public markets to dark pools. "Dark pools of liquidity" is the term for alternative trading systems that do not display quotes to the public, and SEC Chair Schapiro has previously expressed her concern about the two-tiered approach to the market that they create.

SENATE AGING COMMITTEE EXAMINES LIFE TIME INCOME

On Wednesday, the Senate Special Committee on Aging met to discuss lifetime income options, and the proposal to provide "starter annuities" to retiring baby boomers at the point they apply for Social Security benefits. The proposal was developed by the Aspen Institute and would be administered by the Social Security Administration. The purpose of the starter annuities would be to aid retiring workers whose employers don't offer retirement plans (about half the workforce).

Also speaking at the hearing was the assistant secretary of labor for the Employee Benefits Security Administration, who noted that her department received 800 public comment letters in response to its request for information on lifetime income options. The Chair of the Committee, Sen. Kohl, asked the panel for its thoughts on the starter annuities proposal. He was met largely with approval, especially because of the simplicity of the plan in a complex market, although one panelist expressed hesitation and stated that more research must be done in order to cater appropriate retirement solutions for a diverse population.

UPCOMING HEARINGS

On Tuesday-Thursday, June 22nd-24th beginning at 11am each day, in 106 Dirksen, the House and Senate conferees will meet to consider legislation, H.R. 4173, the "Restoring American Financial Stability Act of 2010," that would revise financial regulation.

On Tuesday, June 22nd at 1pm, in Auditorium L-002 of the SEC Headquarters (100 F St NE), the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues will meet to receive testimony by various exchanges and firms regarding the market events of May 6th, and to receive updates from staff and have a discussion of next steps for the Committee.

On Wednesday, June 23rd at 10am, in 215 Dirksen, the Senate Finance Committee will hold a hearing on the U.S.-China Economic Relationship, entitled "Finding a New Path Forward."