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FINANCIAL SERVICES REGULATORY REFORM UPDATE

For the Week of June 21, 2010

CONFEREES CONCLUDE WORK ON WALL STREET REFORM AND CONSUMER PROTECTION ACT – QUICK PASSAGE IN BOTH THE HOUSE AND SENATE IS ANTICIPATED

At the conclusion of a marathon session that started early Thursday morning and ended at 5:39am on Friday, the House and Senate conferees approved the conference report for the Wall Street and Consumer Protection Act (H.R. 4173) on a party-line vote, with House conferees voting 20-11 and Senate conferees voting 7-5 in favor of the legislation. This capped off a more than two year process that began when then Treasury Secretary Hank Paulson laid out a blueprint for regulatory reform back in March of 2008.

Final passage of the legislation is anticipated to occur quickly, with the House expected to vote on the measure Tuesday or Wednesday and the Senate to take it up the following day. Conference reports cannot be amended, and although the Senate can filibuster the motion to go to conference, the vote on the report itself cannot be filibustered. Despite rumors and a few concerns about some ruffled feathers, the legislation is expected to pass and the President has said he will sign it, possibly as soon as the week of July 4th.

Despite claims that this would be the most open and transparent conference process in history, much of the negotiations took place behind closed doors, as the White House, along with Senator Dodd's and Chairman Frank's staff worked furiously through the night and early morning. As with any legislative process, the final product likely contains some unannounced surprises since many provisions were added in at the last minute.

It is important to note that the signing of this bill into law will ostensibly mark the beginning of the "real" reform process, since the legislation requires many of the definitions and applications in the statute to be addressed by regulators. Additionally, we anticipate a significant amount of activity in the near future (i.e., perhaps as soon as the next Congress) to either "clarify" congressional intent, or to provide regulatory relief from these new regulations. In short, despite laudatory press accounts to the contrary, this issue isn't going away anytime soon.

The following is a high level summary of the major provisions of the legislation:

Derivatives:

Perhaps one of the most controversial parts of the legislation, the derivatives provisions were the subject of intense debate, much of it taking place behind closed doors. Despite concerns that Senator Blanche Lincoln (D-Arkansas), the Chairwoman of the Senate Agriculture Committee and the author of the more restrictive Senate-passed language, would not bend, the White House and the banks were able to find a compromise. Although there had been a furious lobbying effort to remove the so-called “Section 716” language (requiring banks to spin off their swaps desks), the language managed to survive the conference, albeit modified.

Under the modified version of this provision, banks and other swaps dealers will be able to maintain their trading operations so long as they deal in “less risky” swaps such as interest rate or foreign exchange swaps, used to hedge risk and not for speculative purposes. For more risky swaps, the banks will have to set up a separately capitalized affiliate within two years.

Additionally, the derivatives title of the legislation created a clearing house system to bring most exchanges into the open market. However, business that use derivatives solely for hedging business risk from producing or consuming commodities, the so-called “end users” will be exempted from the clearing house requirements so long as they are using the derivatives for those enumerated purposes. Finally, regulators will be required to impose heightened capital requirements on companies with large swap positions, and were also provided authority to limit the number of derivatives contracts one trade is allowed to hold.

Volcker Rule:

Conferees voted to include the Obama administration’s proprietary trading ban for banks using a modified version of both the so-called “Volcker Rule” and the so-called “Merkley-Levin” rule. The initial Senate version of the bill (“Volcker”) would have barred banks from sponsoring or investing in private equity and hedge funds, but the agreed-upon legislation will instead limit banks to providing no more than 3% of a fund’s capital. Banks are also prohibited from investing more than 3% of their Tier 1 capital. Sen. Scott Brown, one of only four Republicans to vote in favor of the Senate reg reform bill, was a key reason that this provision was changed – he was concerned that the stricter language would harm Boston-based financial institutions.

Conferees also agreed to give regulators less say than the Senate bill would have authorized. The final bill includes the Merkley-Levin language that clearly defines the limits on propriety trading, as opposed to allowing regulators to determine these limits. These terms have the potential to reduce profits on Wall Street, with firms such as Goldman Sachs taking in as much as 10% of its annual income from proprietary trading.

Merkley-Levin conflict-of-interest language also made it into the final bill, which will prevent firms that underwrite an asset-backed security from engaging in conflicting transactions. The provision is in response to an SEC lawsuit against Goldman Sachs, which was accused of creating and selling CDO’s

without disclosing that a client hedge fund helped pick the underlying securities and bet against the vehicles.

Bank Tax:

In order to pay for the legislation, the conferees accepted language that placed an assessment on certain financial institutions. Opponents of this proposal labeled it a hidden bank tax, and also spoke out strongly against its bifurcated application. Under the language adopted by the conference, financial institutions with assets in excess of \$50 billion in assets and hedge funds in excess of \$10 billion will be assessed a fee to cover the more than \$19 billion dollars in spending created by the legislation. The actual assessment will be determined using a formula developed by the new systemic risk council and collected by the FDIC. According to the legislation, the council will utilize a risk-based matrix to ensure that entities engaged in riskier transactions pay a larger share of the assessment. This proposal is strikingly similar to the framework that the House had included in its version of the legislation to raise the \$150 billion dollars necessary to fund the resolution trust fund (a/k/a the bailout fund). Since passage of a bailout fund was no longer politically feasible, the conferees decided to use the same framework to ensure that the legislation meets Congress' pay-go rules.

Private Equity and Hedge Funds:

In order to avoid increased regulatory scrutiny and burdens (a la what happened to large banks) the private equity and hedge fund industry pushed for the conference to instead impose a Securities and Exchange ("SEC") registration requirement for firms with more than \$150 million in assets. As a result these firms will be subject to periodic inspections by SEC examiners and the firms must hire a chief compliance office and set up policies to avoid conflicts of interests.

Additionally, the firms registered with the SEC will be required to report information about their trades and portfolios that is "necessary for the purpose of assessing systemic risk" to the SEC. The SEC is obligated to keep that data confidential, except for the fact that it can share it with the Financial Stability Oversight Council. That Council, as is discussed below, has the power to make a determination using the SEC-supplied data as to whether a fund has grown too large or too risky, and if so, to place that fund under the supervision of the Fed.

Fiduciary Duty:

Early on Thursday, an agreement was reached as to what level of duty broker-dealers and investment advisors should be subject to when dealing with retail customers. The conferees ultimately scrapped the House proposal to require broker-dealers to operate under a more rigorous "fiduciary duty" standard, and instead kept the language requiring an SEC study on the effects of separate standards for brokers and advisors. While the compromise will allow the SEC to undertake a rulemaking on the subject while the study is going on, the SEC is required to consider the results of the study, effectively delaying the implementation of the proceeding. This study language was included at the behest of Sen. Tim Johnson, who is slated to replace Dodd next year as the Chairman of the Senate Banking Committee, if the Democrats maintain their majority.

Consumer Financial Protection Bureau:

Against the will of Republicans and the banking industry, the Consumer Financial Protection Bureau (CFPB) will be created as a new bureau at the Federal Reserve, to regulate banks and financial services businesses for credit card and mortgage-lending abuses. Although the Obama administration's initial plan for the CFPB to be a free-standing agency was unsuccessful, though it will have independent authority. The CFPB director will be appointed by the President and subject to Senate approval. The bureau will have rule-making authority and will enforce its rules for banks and credit unions with more than \$10 billion in assets. Potentially, the new bureau could require credit card lenders to reduce interest rates and fees, and mortgage lenders could be required to have better disclosure on loan terms to borrowers.

The creation of the CFPB is in direct response to the failures of previous bank regulation leading up to the financial crisis of 2008. The bureau will be taking over much of the consumer protection authority from the Fed, although its rules can still be overwritten by the new Financial Stability Oversight Council if the latter organization decides that the rules threaten the safety, soundness or stability of the U.S. financial system. The provision will take effect one year after enactment of the legislation.

Notably, auto dealers won an important exemption in the reg reform bill, in that they will be excluded from oversight by the CFPB. Thanks to a stellar lobbying campaign, the auto industry will not be saddled with "unnecessary restrictions" on their financing businesses, even though the Obama administration had opposed the exemption.

Financial Stability Oversight Council:

Conferees voted to establish the Financial Stability Oversight Council ("the Council"), which will be a panel of nine regulators, led by the Treasury Department. Other agencies that will be represented on the Council include the Fed, SEC, CFTC, Federal Housing Financial Agency, and others. Non-voting seats will also be given to credit unions and state securities, insurance and banking regulators. The Council will be a "super-regulator" in charge of monitoring the largest financial firms and other market participants, with an emphasis on identifying and responding to systemic risk.

In response to the financial crisis, Congress and others wanted to create an entity with a "macro" perspective on the banking agency, and one that could examine the interconnectedness of highly-leveraged financial institutions. The Council is authorized to impose higher capital requirements on lenders, place broker-dealers and hedge funds under the authority of the Fed, and divest companies of their holdings if they pose a "grave threat" to financial stability in the U.S. In order to take these actions, two-thirds of the Council would have to vote in favor.

Notably, the Federal Home Loan Banks system, which finances mortgage lenders, won an exemption from oversight by the Council because it argued that its lending capacity would be cut in half if there were limits on credit concentration. As was stated above, the Council will have the ability to overrule the CFPB if it deems that the latter's rules threaten the safety, soundness or stability of the U.S. economy. For this

reason, consumers groups such as the center for Responsible Lending objected to this portion of the reform bill.

Federal Reserve:

The legislation will create an expanded supervisory authority for the Fed, in addition to subjecting the organization to the most transparency in its history. The transparency terms were in exchange for removing stricter language that would have removed the Fed's political autonomy and bank oversight authority.

The Financial Stability Oversight Council will share some of its responsibility with the Fed, allowing the latter organization to create new disclosure, capital and liquidity rules. Fed Chairman Ben Bernanke will also hold a seat on the Council.

The Fed managed to avoid potentially strict auditing guidelines, and instead will face a one-time audit of emergency loans and other measures it took during the financial crisis. After a two-year period, the Fed will also have to identify firms that borrow through its discount window and participate in the Fed's purchases and or sales of assets, including mortgage-backed securities.

Although conferees rejected the terms that would have made the New York Fed president a political appointee, they did approve other changes in the appointment of the twelve regional Fed leaders. Commercial banks will now be ineligible to participate in the selection, and instead others chosen by lenders and the Fed's Board of Governors will make the selection.

Federal Insurance Office:

A new regulator will also be created by the financial reform legislation, to oversee insurance companies and make recommendations on how to establish a separate regulatory reform for the insurance industry. Up to this point, insurance companies have been state-regulated, but after AIG's almost-failure and \$182.3 billion taxpayer bailout, Congress decided that federal oversight was also necessary. The final bill establishes the Federal Insurance Office, which will be housed within the Treasury.

Critics are concerned that the new regulator will create a new layer of compliance issues, which will be difficult to fulfill on top of state obligations and will increase costs.

Unwinding Failed Financial Companies:

Conferees agreed to authorize the FDIC to unwind large failing firms whose collapse could cause instability to the U.S. economy. The agency already has the power to liquidate failed commercial banks, but if it had this expanded authority during the financial crisis, it would have been able to seize both AIG and Lehman Brothers. This power will ostensibly prevent using taxpayer dollars to keep a failing firm afloat (as was the case with AIG) and the freezing of credit markets (as was the case with Lehman Brothers after its collapse).

The real question with regard to unwinding failed firms was who would pay for their resolution. Rather than opting for the highly controversial financial industry-sponsored \$150 billion fund, conferees opted to assess financial firms with fees *after* the collapse of an institution. The bill has explicit language barring the use of taxpayer dollars to rescue failing financial companies.

Improving Securitization a/k/a “Skin in the Game”:

As a means of aligning issuers’ interests with those of the investors purchasing their financial products, the reg reform bill will include language forcing lenders to retain some of their risk. The bill excludes some mortgage providers, but will require issuers of credit card debt, auto loans, mortgages and securitized debt to hold at least a 5% stake in the debt that they package or sell. Originators of pools of loans, including some credit card companies, will also be implicated by the skin-in-the-game provision.

Industry lobbyists earned their keep, securing exceptions for many mortgage lenders, who argued that the new rules would tie up capital and lead to higher interest rates. A different exemption exists for sellers of commercial mortgage-backed securities, who will be subject to customized risk-retention rules for specific products, as determined by the appropriate regulators. Mortgages with elements of increased risk, such as negative amortization, interest-only payments and balloon payments, will not be exempt.

Loans guaranteed by the Federal Housing Administration, USDA and U.S. Department of Veterans Affairs will be exempt from retaining risk, and these agencies jointly guaranteed more than 30% of new mortgages last year.

Interchange Fees:

Sen. Durbin’s interchange fee language made it into the final version of reg reform legislation, with the Fed receiving new authority to limit the fees that merchants pay for each debit card transaction. The provision allows retailers to refuse credit cards for purchases under \$10 and offer discounts for other forms of payment. The Fed will also be granted authority to issue rules allowing merchants to route debit card transactions on more than one network, which would create more competition in the market, according to Durbin.

This provision will ensure that interchange fees are “reasonable and proportional” to the cost of processing transactions, and will exempt all lenders with less than \$10 billion in assets – 99% of U.S. banks.

Unsurprisingly, the credit card industry lobbied hard to stave off interchange fee legislation. Last year alone, Visa and MasterCard interchange fees totaled \$19.7 billion and averaged 1.63% of each sale. The fact that this provision will not affect lending practices (because debit card funds come directly from consumers’ checking accounts) may have helped gain Republican support.

Capital Requirements:

Sen. Collin's provision, which was backed by the FDIC, was agreed upon and will bar bank holding companies from keeping less capital than their bank subsidiaries. The language will also impose the same rules on U.S. holding companies of overseas banks (e.g. Barclays). Up to now, these entities have been exempt so long as the foreign parent was regulated by an organization recognized by the U.S.

The measure is expected to impact the use of trust preferred securities - there will be a transition period for large firms and a grandfathering of securities for smaller lenders. Both of these conditions reflect the efforts by banks to curtail this provision. Community banks that have used trust preferred securities to raise cash will essentially get 20 years to replace these securities (because most have 30-year maturities and were purchased in 2000) with common stock or other securities that fall under the definition of capital. Banks with assets of \$15 billion or more will have five years to make the same switch. Up to this point, trust preferred securities counted towards equity when calculating capital ratios, but were treated like bonds for tax purposes.

According to Moody's, the provision will have minimal effect on banks' ratings because trust preferred securities are already disqualified as capital by analysts. Barclay's Plc President Robert Diamond and bank lobbying groups have all stated that this measure could disadvantage U.S. businesses and consumers because it could restrict lending by as much as \$1.5 trillion.

Credit Rating Agencies:

The credit rating measures that made it into the final reg reform bill will not be nearly as strict as they might otherwise have been. Rather than regulators selecting which agencies grade asset-backed securities on a rotating basis, as was proposed by Sen. Franken, the SEC will instead conduct a two-year study on whether to create a board that would make this selection. Once the study is complete, the board would be established unless regulators come up with a more effective solution.

The final legislation also creates a new pleading standard for lawsuits against credit rating agencies, such that plaintiffs must now demonstrate that a company "knowingly or recklessly" failed to conduct a "reasonable" investigation before issuing a rating. The House bill would have required a lower threshold of evidence ("grossly negligent"), and the current law requires plaintiffs to demonstrate that they were intentionally misled. The final bill also includes language stating that hiring an outside company to run investigations would preclude credit ratings agencies from being sued. Legal experts note that this creates an incentive for credit rating agencies to properly perform their due diligence, but also doesn't open the floodgates to an onslaught of lawsuits.

Corporate Governance:

House conferees agreed to use Senate-approved language in the final reg reform bill, which would require the SEC to engage in rulemaking on shareholder elections of board members. The language would require public companies to give shareholders with more than 5% of outstanding shares for at least two years the right to nominate and elect members of the company's board of directors by proxy. The SEC will also be

allowed to exempt small businesses from the requirement, but will not be obligated to do so. Reportedly, the SEC has been working on this proxy access language since 2003, but was only given the authority to make it official now.

THE EXTENDERS BILL AND CARRIED INTEREST

On Thursday night, the Senate failed yet again – for the third time – to pass the American Jobs and Closing Tax Loopholes Act (“the Extenders bill”), H.R. 4213. Senate Majority Leader Reid pulled the bill from the floor, after Republicans expressed their disapproval of the more than \$100 billion package that would aid unemployed Americans and underfunded states. The repeal of carried interest provision continues to be highly contentious, and was cited as a key reason that Sen. Nelson joined the Republican opposition to the Extenders bill. Nelson was quoted as saying that real estate partnerships, which will be significantly affected by the carried interest repeal, play an important role in the economies of *every* state, as opposed to other financial institutions that tend to be concentrated in New York, California and Illinois.

It is uncertain whether the carried interest provision will be voted on at all this year – whether in the Extenders bill or another piece of legislation. Considering the proximity to mid-term elections and the contentiousness of the carried interest provision, it may get put off until next year. Other elements of the Extenders bill, however, have the potential to show up in upcoming legislation, including a “doc-fix” bill which would temporarily reverse steep Medicare pay cuts, and the Small Business Lending Fund Act, which will be on the Senate floor next week.

BASEL COMMITTEE TO MAKE WATERED DOWN RECOMMENDATIONS AT G20

At this weekend’s G20 summit in Toronto, long-term liquidity standards will no longer be on the table, as the Basel Committee will be revising its initial proposal for banks to maintain a “net stable funding ratio.” The Basel Committee on Banking Supervision formulates broad supervisory standards and guidelines on best practices in banking supervision. Initially, the Committee had suggested that banks set aside billions of dollars in extra capital to cope with future crises, but after months of strong lobbying efforts by the banking industry, this proposal has been set aside.

The Basel Committee will be presenting the rest of its proposals at the G20 this weekend, and is expected to replace its controversial liquidity standards with an alternative system of oversight. Critics of the initial Basel proposal stated that it had the potential to increase funding costs and borrowing charges for customers, and could have cost the industry as much as 5,000 billion euros. In some parts of the world, new taxes are being imposed (e.g. the new liability tax in the UK), and in combination with new liquidity standards, this could in theory cut an average bank’s return on equity from 20% to 5%.

More likely to occur in Toronto is the creation of a basic foundation for rules, and allowing individual countries to work out the more contentious aspects of financial regulation within their own borders.

UPCOMING HEARINGS

There are no upcoming financial services hearings in the House or Senate. We will keep you informed as we learn more.