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FINANCIAL SERVICES REGULATORY REFORM UPDATE

For the Week of August 2, 2010

We hope you've enjoyed our weekly updates about the major issues percolating in Washington, D.C. that could impact the financial services industry. It has certainly been a busy year and we hope these updates have been helpful to you, and have provided valuable insight into the legislative process. During the month of August we will be taking a little break to recharge our batteries, but will resume these weekly updates when Congress returns in September.

However, although the battle on Wall Street Reform has appeared to shift from Congress to the federal agencies, Congress and Congressional staff will continue to play an important role in the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Whether in the much hyped, though not ready for public discussion technical corrections bill, or through their own efforts to convince the agencies of the meaning of their own words, the real battle about financial reform -- the interpretation of the words on the 2300 plus pages of the law -- is just starting.

If you are interested in shaping, mitigating the effects of, or outright changing the implementation of this law, we would be delighted to provide strategic advice to assist you in this goal. We believe that ML Strategies is well positioned to offer you cost-effective strategic consulting to assist you, and please feel free to contact me (jrosenstock@mlstrategies.com).

Finally, if you think there is someone who should be receiving these updates, please feel free to provide me with their email address so that I can add them to our distribution list.

RUMORS ON WARREN AS CFPB CHIEF CONTINUE - AS FOUNDATION OF BUREAU BEGINS TO BE BUILT

As Elizabeth Warren, a Harvard Law professors and chair of the Congressional Oversight Panel, remains the lead candidate for the director of the newly-created Consumer Financial Protection Bureau (CFPB), more information is beginning to surface about her background and political leanings. In an effort to counter talking points that she leftist and anti-market, multiple stories this weak quoted many "close to her" who described her as rather moderate with a genuine respect for the efficiency of markets. Despite these efforts, Ms. Warren remains highly controversial on Wall Street, and certain political quarters, consumer advocates of every political leaning have endorsed her nomination. She is therefore still somewhat controversial and it remains to be seen whether President Obama will make a recess appointment of Warren.

Regardless of who ultimately is named to head the CFPB, the organization still needs to be created from scratch. Last week, Treasury Secretary Timothy Geithner met with Federal Reserve Chair Ben Bernanke, FDIC Chair Sheila Bair, FTC Chair Jon Leibowitz, HUD Secretary Shaun Donovan, National Credit Union Administration Chair Debbie Matz, Comptroller of the Currency John Dugan and Office of Thrift Supervision acting Director John Bowman, to kick off the staffing and organizing of the Consumer Protection Financial Bureau (CFPB). In the meeting, the agency heads agreed to appoint liaisons from their respective staffs to help Secretary Geithner's implementation team coordinate the transition of the new bureau. One of the first expected tasks will be a letter informing consumer protection employees in each of the agencies that they could be asked to transfer to the CFPB in the next 18 months.

Under Dodd-Frank, the Treasury Department is the caretaker of the CFPB until a permanent director is nominated by the President and confirmed by the Senate. The Treasury is expected to set a target date for transferring staff and responsibility from other agencies to the new bureau by the end of September. The CFPB is expected to have a staff of several hundred, and independent funding of about $500 million annually, though it can ask Congress for additional appropriations.

Treasury Deputy Secretary Neal S. Wolin also noted that even without an appointed director, the government is already starting to work on substantive issues and getting the CFPB up and running, with many taking bets on which consumer financial services product will be the first agenda item of the new bureau.

DODD-FRANK: THE FALLOUT BEGINS

Even though many of the new regulations under Dodd-Frank won't take effect for years, Wall Street is starting to see some action as firms move swiftly to shake up their trading desks, private equity branches and other aspects of their firms to keep employees from leaving for hedge funds that will be less-affected by the new legislation. Morgan Stanley, for example, is close to finalizing a deal in which it would relinquish control of FrontPoint Partners, an in-house hedge fund, bringing its ownership down to between 20 and 25%. The negotiations had been on-going for more than a year, after Morgan Stanley paid about $40 million for FrontPoint as recently as 2006. Morgan Stanly is also determining what to do with another large proprietary-trading operation, which will be interesting in light of new CEO James Gorman's assertions that proprietary risks or investment vehicles with large downsides are not worth the potentially enormous profits.

Goldman Sachs is also deciding what to do with its two large proprietary trading desks, in light of the new Dodd-Frank restrictions and the Volcker Rule specifically. Some insiders say that the firm is not considering closing down, selling or spinning off the private equity business units, but others say that no final decision has been made and Goldman will be determining what to do over the course of the next few months. One of the plans being discussed is spinning of the proprietary trading unit, which consists of dozens of traders, into an independent hedge fund. Goldman's proprietary trading and private equity investments make up about 10% of the firm's revenue (more than its rivals) because of

CEO Lloyd Blankfein's interest in risker and more lucrative activities. Another plan under discussion is to move some proprietary traders into Goldman's asset management division, which insiders say will be determined by the compensation structure – the employees in question are some of the most well-paid at the firm.

Treasury Secretary Geithner laid out a very specific plan for the implementation of Dodd-Frank earlier this week, particularly noting that the process would be transparent and the public would have an opportunity to participate in it. First, he stated that the government has an "obligation of speed" to write rules more quickly than in the past, in order to reduce uncertainty for all the affected players - though he didn't specify a specific timeline. Second, Geithner stated that the government will not risk stifling innovation by imposing too strict regulations on firms that would inhibit their ability to develop innovative financial services and products. Third, the government will streamline the regulatory framework, including eliminating ineffective rules. Fourth, there will be more order and coordination to the regulatory process, and fifth, the government will be consulting broadly and publishing each rule for public comment before it is made final.

Geithner also detailed the approach that the administration endorses for increasing capital requirements for financial institutions. Under this approach, all firms would be subject to two tiers of capital requirements – a "substantial minimum" of capital, and a "buffer" level of capital. If the first level is wiped out and the buffer level begins to be depleted, the firm will be required to raise additional capital, reduce dividends or suspend share repurchases. Geithner did not specify the exact capital requirement level preference, but did add that "they need to be substantially higher than they were." He also stated that banks will be given a "reasonable" transition period to adopt new capital requirements – until the beginning of 2013 for new minimums and several years beyond that for the buffer second tier.

In a speech given on Thursday at the New England Council, Treasury Deputy Secretary Neal S. Wolin spoke about the government's plans to make public a priorities list of all the requirements created under Dodd-Frank. He stated his hopes that this list will be public by the end of the year, after all the agencies have an opportunity to outline their plans of action and create a timeline for public comment on draft rules. Wolin noted that the "rigorous implementation process" has begun, but that it will take some time.

Wolin also spoke about consumer protection measures, we he asserted would be "better regulation," as opposed to simply *more* regulation. He stated that the government will be acting quickly to reconcile forms under the Real Estate Settlement Procedures Act and the Truth in Lending Act, and giving consumers simpler disclosures for credit cards, auto loans and mortgages. The government will also be inviting public comment on new national underwriting standards for mortgages so reforms on the mortgage market can begin to take shape.

Wolin also laid out a few initiatives on which the government is already working, including reforming government-sponsored entities and the broader housing finance system. The Treasury will be hosting a conference on the future of housing finance on August 17th, and will be putting forward a plan for

reform early next year, including input from the August conference. The Treasury will also be working with the Federal Reserve, the SEC and the CFTC to "outline specific quantitative targets for moving standardized derivatives trades onto central clearing houses." Wolin stated that the government plans to act quickly to implement these derivatives reforms, including working with the international community to create global standards for the derivatives market. Finally, the government is working on a global effort to establish new capital rules to "constrain excessive risk taking and leverage in the largest global financial institutions." Wolin singled out bigger firms and more complex, interconnected firms as needing higher capital requirements than their smaller peers, and that these requirements will be supplemented with new global standards for liquidity management as well. He did add that though the government will be acting swiftly, it will also be acting carefully, with a reasonable transition period (echoing Geithner's statements as well).

THE SEC'S BUSY SCHEDULE

Out of concern over one of the Dodd-Frank Section 929I, which amended the 1934 Securities Exchange Act, the 1940 Investment Company Act and the 1940 Investment Advisers Act to provide that records obtained from registered entities can be kept confidential by the SEC if obtained as part of its regulatory and oversight activities, including its risk-assessment and surveillance functions, our Senators – Kaufman (D-DE), Leahy (D-VT), Grassley (D-IA) and Cornyn (R-TX) introduced a bill on Thursday that would eliminate the language entirely. Many legislators are concerned that this language gives the SEC too much discretion over transparency, and would allow the agency to assert an exemption from Freedom of Information Act (FOIA) requests.

The four Senators also wrote a letter to SEC Chair Schapiro, urging her to "narrowly" interpret and apply the Section 929I exemption. In letters to House Financial Services Committee Chair Barney Frank (D-MA) and Senate Banking Committee Chair Chris Dodd (D-CT), Schapiro stated that the bill "does not provide a 'blanket' SEC exemption from FOIA oversight and is not designed to protect the SEC as an agency from public oversight and accountability." Nevertheless, Kaufman, Leahy, Grassley and Cornyn went ahead with their proposed legislation, which would eliminate the provision entirely, while ensuring that the SEC can preserve the confidentiality of sensitive information from regulated entities. The bill would also ensure that hedge funds and other SEC-regulated entities are classified as "financial institutions" for FOIA-related purposes, which would treat hedge fund information the same as information from other financial institutions. The four Senators also stated that this bill is intended to put the SEC on the same footing with regard to transparency as other agencies. Former SEC enforcement lawyer Gary Aguirre also commented that "Congress missed a golden opportunity with the Dodd-Frank Act to bring a small measure of transparency" to the SEC, and that already-difficult FOIA requests would now become almost impossible.

Rep. Frank announced that the House Financial Services Committee will be holding a hearing on September 23rd to "explore concerns" about Section 929I and the potential discouragement of transparency at the SEC. He added that holding the hearing on September 23rd will give Congress ample time to take corrective action, if necessary.

The SEC is also expected to make a final "proxy access" rule this month, which would allow large shareholders directly nominate directors on corporate ballots alongside the company's nominees. The vote is expected to be 3-2 on August 25th (the next scheduled meeting), with the two Republican commissioners dissenting. As the current law stands, if the shareholders want to propose a director, they need to pay out of pocket for a proxy fight, and it is very difficult for dissenting shareholders to unseat incumbent directors. Under the new rule, the company would bare the burden of the costs.

Interestingly, in the initial drafted language, only shareholders who hold at least a 3% stake in the company for at least two years would qualify to nominate a director, though these specifics may change in the final rule. In a previous draft of the proposal, the SEC would have imposed a tiered system, with a 1% stake needed for large companies, 3% for mid-sized companies, and 5% for small companies. Since then, the SEC accepted the recommendation of the Council of Institutional Investors to have an across-the-board 3% rate, to the objection of the U.S. Chamber of Commerce and the Business Roundtable. Proxy access has been discussed at the SEC since 2003, and current Chair Mary Schapiro made a proposal in June 2009 with the promise of a rule in place for next year's proxy season.

Also at the SEC, just days after Dodd-Frank was signed into law, the Division of Corporation Finance updated its Compliance and Disclosure Interpretations (CDIs) to include interpretive advice regarding the law's new net worth standard for accredited investors. These CDIs are not SEC rules or statements, and they have not been approved or disapproved – they are merely a reflection of staff views. Specifically, the CDIs addressed how to determine the "value of the primary residence" for calculating a person's net worth, and noted deficiencies in the law in terms of the definition of "value" and addressing the treatment a mortgage or other indebtedness secured by the residents for purposes of the net-worth calculations. SEC staff stated that the agency will engage in rulemaking to clear up any discrepancies, and that the value of a person's primary residence should be excluded in determining net worth. Further, while awaiting implementation of the required rule changes, "the related amount of indebtedness secured by the primary residence up to its fair market value may also be excluded. Indebtedness secured by the residence in excess of the value of the home should be considered a liability and deducted from the investor's net worth."

GOVERNMENT SPONSORED ENTITIES REFORM

The question of how to reform government sponsored entities Fannie Mae and Freddie Mac, which together own or guarantee about half of the nation's $11 trillion home mortgage market, continues to perplex members of both the government and the industry. President Obama will be holding a conference on the future of housing on August 17th as a means of seeking advice on mortgage finance regulatory reform, and his goal is to have a proposal to Congress by January. For now, the contents of that proposal continue to be up in the air, with some arguing for the complete extinction of the two GSEs and others conceding that the government will probably have to play some role in mortgage finance.

Additionally, the House Financial Services Committee will be holding hearings in September to examine policy options for restructuring the U.S. housing finance system. House Capital Markets, Insurance and GSE Subcommittee Chair Paul Kanjorski (D-PA) will be conducting an oversight hearing of the GSEs. The full Senate Banking Committee will be holding hearings on covered bonds, and one of its subcommittees will be holding a hearing on international mortgage finance systems.

Geithner has stated that Fannie and Freddie are in need of “sweeping, fundamental change,” and they “are not tenable for the future.” Geithner assured that any U.S. housing finance reform would still have to allow qualified homebuys to access credit for purchasing homes, even in an economic downturn. He confidently stated “it’s not going to be hard for us to fix” housing finance, but conceded that the challenge lies in building political support for reform.

In a touch of irony, Fannie Mae stock, which is almost worthless, has become “the nation’s hottest penny stock,” according to the NY Times. Since June, about 31 million of Fannie Mae shares have been traded on a typical day, which is more than triple the average for Goldman Sachs shares. On Wednesday, the stock closed at 40 cents, though it had been as high as $85 per share before the house market imploded in mid-2007. Because of its current low value, even the smallest change in prices translates into huge percentage gains and losses, which are swinging wildly thanks to the day traders who hold the stocks for a few hours at a time.

The federal government owns 80% of Fannie Mae and Freddie Mac stock, and earlier this year the Vanguard Group and BlackRock owned about 1.2% of the company. For the most part, big investors are loathe to invest in the GSEs – the New York Stock Exchange officially dropped both in July because their share prices were below $1 for more than 30 days in a row. Now, the stocks are traded on the OTC Bulletin Board, along with other penny stocks and thinly traded “microcap” companies.

DODD SHIFTS FOCUS TO INTERNATIONAL HARMONIZATION OF REG REFORM

Senator Chris Dodd (D-CT), who will be retiring at the end of this year, plans to push for common international standards on derivatives in the final months of his term. In a statement on Wednesday, he conveyed his concerns about “sovereign arbitrage,” as nations create safe harbors where global financial firms can take their business without any fear of restrictions. The derivatives market is particularly worrisome because it represents over $500 trillion dollars, and there is still a great need for uniform requirements establishing transparent exchanges and clearinghouses. Dodd was specifically concerned that Europe might not require over-the-counter (OTC) derivatives to be placed on public exchanges in a parallel manner to the U.S. financial regulatory reform. The European Commission is currently revising its rules regarding OTC swaps trading, but is not likely to include an exchange requirement in the proposal it will introduce next month.

Dodd stated that he will do “all [he] can” in the months leading up to his retirement, including attending the upcoming G20 Summit in Seoul, South Korea, and holding Senate Banking Committee hearings in September on the Basel III accords. With regard to the G20, Dodd would also like to see

the establishment of a principal group with which U.S. regulators can regularly meet in the lead-up to international summits.

Additionally, Dodd spoke about the resolution authority provisions created under the Wall Street Reform and Consumer Protection Act, and how they may need further refinement. The new law creates authority for the FDIC to unwind large banks and non-bank financial firms, but it remains unclear how that authority will mesh with existing corporate bankruptcy laws. Dodd stated his concern that government intervention would be the default option if a major financial firm failed today, and that bankruptcy should be the "preferred option." However, Dodd also stated that bankruptcy laws are themselves in need of an overhaul, because today's highly interconnected companies are complicated and the laws "don't handle that really well."

UPCOMING HEARINGS

The Senate and the House of Representatives will be in recess until Monday, September 13th.