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FINANCIAL SERVICES REGULATORY REFORM UPDATE

For the Week of May 10, 2010

The Senate continued its prolonged debate on the Regulatory Reform bill this past week, but it appears that the end is in sight. Senate Majority Leader Reid indicated his intention to file cloture on Monday May 17th, which would ripen for a vote on Wednesday the 19th. Votes were expected throughout the day on Monday, but with Democrats down at least two votes due to Tuesday primaries, the general consensus was that anything brought up on Monday or Tuesday would be destined to pass or fail by overwhelming totals. Pushing Reid to "clear the deck" as possible is both a sense that the longer this drags out the more "unworkable" the bill becomes with a populist fervor gripping the Senate, but also there is a clear sense that Reid needs to try to bring up the "must-pass" tax extenders and supplemental defense spending bill before the Memorial Day recess.

There is also talk of a Senate Finance Committee mark-up of the small business jobs bill this coming week. Insiders say the bill will in fact include a bonus depreciation provision, that would be applied retroactively, and the Committee hopes to pass it on to the full Senate by the end of the month, though rumors continue to persist that the tax writers will modify the treatment of private equity, hedge funds, venture capital and others use of carried interest as one of the revenue raisers for this legislation.

SENATE CONTINUES TO DEBATE REG REFORM – WITH A FEW SURPRISES:

During the last week the Senate took up numerous amendments, dispatching with some by voice vote and eight by roll calls. The following is a summary of some of these amendments.

After an unsuccessful vote on his original amendment to require a broad audit of the Federal Reserve, Senator Sander's second attempt passed unanimously (96-0). Sanders reached a compromise with Senator Dodd, so that the amendment would only require a GAO audit of more than $2 trillion in emergency lending by the Fed during the banking crisis (since December 2007), and also include the Feds' efforts to boost the MBS market, the commercial paper market, and other programs. The measure would also allow the GAO to examine potential conflicts of interest of Fed regional bank directors, who are selected by member banks, but would preserve the prohibition on audits of the Fed's monetary policy deliberations. The House-passed version of this amendment is written much more broadly, and Rep. Ron Paul (the sponsor) referred to Sanders' passed amendment as "good, but not nearly enough," which could raise complications when the two reg

reform bills go to conference. Senator Vitter's amendment, which was similar to Sanders' initial amendment and had parallel language to the House bill, also failed by a vote of 37-62.

Senator Chambliss' proposed amendment to Senator Lincoln's derivatives bill was voted down – 39-59, with two Republicans joining the Democrats to vote against it. Chambliss's proposal would have softened derivatives provisions in reg reform by requiring only certain transactions made by swap dealers and major swap participants to be cleared through a clearinghouse and traded on public exchanges. He would have given the SEC and CFTC the authority to determine which swaps would have to be cleared. Lincoln's bill requires clearing for all derivatives, with a small exception for those used to hedge actual business risks. Chambliss touted his amendment as "more targeted" and "designed to reach those who are actually responsible for the crisis that we're in," whereas Lincoln accused Chambliss of attempting to "weaken the bill and riddle it with loopholes."

Still to be determined in the derivatives bill is the highly-contentious provision requiring financial institutions to divest of their swap desks in order to be eligible for emergency federal assistance. Lincoln clarified that her bill would not ban swaps from companies receiving aid, but would swaps to be conducted by a separately capitalized affiliate of the company. Democrats, Republicans, and the financial industry have all expressed reluctance about supporting this provision, and Dodd could potentially revise the terms when he introduces a manager's amendment, though this issue depends more on how the results of Ms. Lincoln's May 18th primary turn out. If she pushes that election into a run-off, there is speculation that Dodd may refrain from dealing with this issue in his manger's amendment and instead will wait till conference to "clean it up."

A bipartisan amendment, offered by Senators Landrieu and Isakson, was adopted unanimously on Thursday. It would exempt certain mortgage products from the bill's risk retention requirements, and require banking regulators to establish a category of soundly underwritten residential mortgages that could be fully securitized. Essentially, the amendment scaled back a portion of the reg reform bill that would require mortgage lenders to retain a small portion of MBS's that are sold to investors. Similarly, Senator Crapo's amendment directing banking regulators to consider exemptions or different risk retention requirement for CMBS's was approved by a voice vote, also on Thursday.

Senator McCain offered a failed amendment that would have ended the conservatorship of Fannie Mae and Freddie Mac, and spun them off as private businesses. All Republicans and two Democrats – Senators Bayh and Feingold – voted in its favor. Dodd's competing amendment won passage, by all remaining Democrats and 6 Republicans (Senators Brown, Collins, Johanns, Murkowski, Snowe and Voinovich), and will require the Treasury Secretary to study and make recommendations to Congress on ending the conservatorship of the two government-sponsored enterprises (GSE's).

Senator Thune's amendment to sunset the new Consumer Financial Protection Bureau failed by a vote of 40-55. It would have required congressional reauthorization of the new regulator after four years. Senator Sessions also offered a failed amendment that would have created an orderly and transparent bankruptcy process for nonbank financial firms. Dodd noted that Sessions' proposal

would effectively undo all the bipartisan negotiations that had already resulted in a Senate endorsement of resolution authority language.

Senator Bennet's bill passed by a voice vote, and would require unspent funds from TARP and other stimulus programs to be returned to the Treasury if unused by the end of 2012. Two credit rating agency amendments were passed by Senators Franken and LeMieux, in a relatively popular attempt to punish the industry. Franken's amendment, adopted by a 64-35 vote, would authorize the SEC to establish a board to assign agencies to rate new issues of ABS's, in the same way courts assign cases to judges. LeMieux's amendment was adopted by a 61-38 vote, and would remove all statutory references to credit rating agencies in federal law, allowing the private market to resolve the issue. Rather than relying on the SEC's current definition, LeMieux's language would require regulators to create a different measure of creditworthiness within two years.

SENATE PASSAGE OF INTERCHANGE FEES LEADS TO QUESTIONING OF BANKS CLOUTS

On Thursday, Majority Whip Durbin passed his controversial reg reform amendment, giving the Fed powers to reduce bank fees charged to merchants for processing debt card transactions. The 64-33 vote was a victory for retail groups, and included 17 Republicans, who were lobbied hard by convenience store owners on the polarizing issue. Durbin's language requires the Fed to establish "reasonable and proportionate" fees for debit transactions, and exempts institutions with less than $10 billion. Major network operators (i.e. Visa and MasterCard) would also be prohibited from establishing rules that would prevent merchants from giving preference to a particular brand of card based on the fees, or a discount for paying in cash. Up to now, the two card companies charge about 1-2% of the transaction cost for every credit card transaction that a merchant accepts, adding up to almost $50 billion annually.

Legislators had previously tried to avoid directly dealing with this issue and in a 2009 debate over credit card regulation overhaul, Dodd attempted to tiptoe around the matter by pushing a study of the issue. In order to gain enough support, Durbin modified his proposal to create a $10 billion dollar threshold for banks/credit unions to fall under these regulations, which, as he noted, would exempt close to 99% of all banks and credit unions from the law.

FED RETAINS OVERSIGHT OF STATE BANKS

In a resounding 90-9 vote on Wednesday, the Senate voted in favor of the amendment of Senators Hutchison and Klobuchar that would allow state-chartered institutions and banks with less than $50 billion in assets to continue operating under Fed supervision. Under the initial reg reform bill, the Fed would have lost responsibility for approximately 850 state-chartered banks and 5,000 bank holding companies it currently supervises. Dodd had proposed transferring bank supervision to the FDIC and the Office of the Comptroller of the Currency. Community banks and the Fed had lobbied against Dodd's initial language, which they argued would have caused the Fed to lose valuable insight into the health of the entire banking system, because it would only be monitoring the nation's largest banks.

IN THE PIPELINE – ANTICPATED AMENDMENTS

Although Reid is anticipated to file cloture on Monday, that would still allow for two days for additional amendments, but would still allow for the consideration of germane amendments (albeit under a more rigorous 60 vote threshold). Among those amendment expected to be considered include, a package introduced by Senators Levin and Kaufman, intended to safeguard against certain practices on Wall Street. These amendments are directly in response to a series of Senate Committee hearings organized by Senator Levin which examined Wall Street activities and include a comprehensive set of amendments to stymie abusive loans, misleading credit ratings, poor quality securitizations, and the revolving door for regulators. Additionally, they have joined with Senator Merkley that would limit proprietary trading and conflicts of interest by financial institutions.

Still to come next week are a variety of securities-related amendments, which would impose a fiduciary duty on certain broker-dealers, transform the SEC from federally-funded to self-funded, and create private rights of action against market participants such as credit rating agencies. Senator Grassley, after calling into question the objectivity of the SEC in investigations such as the Madoff one, introduced an amendment that would slow the "revolving door" in which employees of the federal financial regulators leave the government for lucrative jobs on Wall Street. His measure would require these former employees to disclose their new roles, and ban them from representing clients before their former employer for a period of two years.

Also expected to be considered is an amendment offered by Senator Brownback's amendment to exempt auto dealers from the regulations and enforcement of the proposed Bureau of Consumer Financial Protection. It is rumored that despite the fact that the President personally weighed in against Brownback, the auto dealers had the votes to surpass the fifty vote threshold. As a result, Chairman Dodd put consideration of the amendment on hold in order to require Senator Brownback to surmount a more rigorous sixty vote threshold.

UNDERSTANDING THE MAY 6TH STOCK MARKET PLUNGE

On Tuesday, the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held a hearing to examine the stock market "flash crash" of Thursday, May 6th. Chairman Kanjorski stated his concern about the panic that can ensue from technological problems, regulatory loopholes and human blunders, and aimed to gain insight on what exactly caused the drop. Panelists included the heads of the SEC, CFTC, New York Stock Exchange and NASDAQ, and all agreed that the market dive was "unacceptable," though no actual cause was ever pinpointed.

Conjectured origins of the plummet included the financial meltdown in Greece, uncertainty surrounding British elections, an upcoming jobs report, an "algorithmic error" in the computerized trading systems, and an anomalous trader who accidentally entered "billion" instead of "million" for a short-sell on the S&P 500, which caused high-frequency traders to scramble and liquidity to vanish (this final hypothesis is unsubstantiated). Experts agree that regardless of the source of the problem,

the volatility of the market was undoubtedly exacerbated by high-speed trades and automatic sale orders that are infinitely faster than the antiquated manual system.

Kanjorski said he felt "a lot more secure" after hearing Chairman Schapiro of the SEC speak, though not all Subcommittee members were in agreement. " Schapiro testified that the SEC is committed to finding solutions in the very near future, and that an agreement already exists with major securities exchanges with the stated objective of strengthening trading restraints with regard to big market fluctuations. Earlier this year, the SEC had already begun a "broad review" of the equity market structure, including an assessment of whether market structure rules have kept pace with trading technology. Schapiro did add that last week's events add greater urgency to the SEC's pursuit of several initiatives to promote investor confidence.

Senator Kaufman was not as confident as Kanjorski, and stated that the SEC "must not look for quick fixes, but meaningful reform." He accused the SEC of failing to make use of its existing authority to properly analyze the events of May 6th. The SEC twice proposed, but never finalized, a rule in 1991 and 1994 that would mandate trader reporting. The SEC proposed a similar rule, identifying market participants who trade large blocks of stock, this past April, but is unlikely to finalize it until the summer, which Kaufman called "inexcusable." In response, Kaufman and Senator Warner are creating a reg reform amendment that would direct regulators to study and report to Congress "in a timely manner what is needed to prevent another meltdown."

As is noted below, the Senate will also be examining the same issue this coming Thursday, May 20th.

THE "CIRCUIT BREAKER"

This past February, the SEC adopted a "circuit breaker" rule (Rule 201), an imperative designed to limit short-selling where an individual stock is under stress and has experienced a decline of 10% from the previous day's close. This is particularly relevant in light of the May 6th stock plunge, although the deadline for the regulated community to come into compliance is not until November 10th of this year. As of Friday, the SEC is still speaking with firm and industry groups to work out implementation issues, and Tory Crane, the branch chief of the SEC's Division of Trading and Markets stated that she is unsure how the fallout from May 6th will affect short sale restrictions. The SEC's Rule 201 would temporarily halt short selling of a stock if the price falls more than 10% in a day compared to the previous day's closing price. Short selling of that stock can only resume in the next couple days at a price above the current national best bid. Listing markets are responsible for identifying the stocks that decrease by 10%, and must then notify "single plan processors," who must then disseminate the information to the markets. The compliance burden is almost entirely on trading centers, which must have policies and procedures in place to impose the short sale restrictions, and will cost almost $1 billion. Crane noted that data is currently unavailable as to whether the circuit breaker would have prevented the May 6th stock plummet if the new rule had already been in place.

The head of FINRA, Yvonne Huber, called the SEC rule "complicated and very technology-driven." FINRA is also preparing for the new requirements because it will be monitoring the

broker-dealers' and trading centers' compliance. The associate general counsel for regulatory affairs at E*Trade Brokerage Services noted that this is a "huge IT project."

PRIVATE EQUITY TO PAY FOR THE TAX EXTENDERS BILL?

The House has put forth an aggressive schedule for passage of its tax extenders legislation, which includes pay-for provisions that would alter taxation of certain carried interests. Carried interest, the portion of investment profits that fund managers are permitted to retain as compensation, has been scrutinized under the current system, which some argue permits these fund managers to pay lower tax rates.

The extenders bill is being packaged with spending measures, which include an extension of unemployment benefits that are set to expire next month. Democrats are touting the carried interest provisions as a new level of fairness in the tax code, while Republicans are expressing their concern that the new taxation will hurt the economy. The Treasury's Office of Policy is specifically critical of the broad definition of "investment services partnership interests" (ISPI's), which would be subject to the new carried interest tax regime. He added that the Treasury and the IRS would likely issue guidance quickly to address open issues, which also include ambiguity as to the role of qualified capital interests in the legislation. Industry experts were skeptical that these and other issues could be resolved before final passage by the two chambers.

Although a seemingly esoteric issue, this dispute on taxation "cuts to the heart of ideology for both parties." House Democrats want to raise taxes on hedge fund managers and venture capitalists to pay for an extension of popular tax breaks.

UPCOMING HEARINGS

On Monday, May 17th at 1pm (CDT), in room 252 of the Dirksen Federal Courthouse, the Subcommittee on Oversight and Investigations of the House Committee on Financial Services will hold a field hearing entitled "Commercial Real Estate: A Chicago Perspective on Current Market Challenges and Possible Responses."

On Tuesday, May 18th at 1pm, in 2128 Rayburn, the House Committee on Financial Services will hold a hearing entitled "Initiatives to Promote Small Business Lending, Jobs and Economic Growth."

On Thursday, May 20th at 10am, in 538 Dirksen, the Senate Committee on Banking, Housing and Urban Affairs' Subcommittee on Securities, Insurance and Investment will holding a hearing to examine the causes and lessons of the May 6th market plunge.

On Thursday, May 20th at 2pm, in 2128 Rayburn, the Subcommittee on International Monetary Policy and Trade and the Subcommittee on Domestic Monetary Policy and Technology of the

House Committee on Financial Services will hold a joint hearing entitled "The Role of the International Monetary Fund and Federal Reserve in Stabilizing Europe."

On Friday, May 21st at 10am, in 2128 Rayburn, the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Committee on Financial Services will hold a hearing entitled "Accounting and Auditing Standards: Pending Proposals and Emerging Issues."