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FINANCIAL SERVICES REGULATORY REFORM UPDATE

For the Week of June 28, 2010

As was widely reported, after concluding the conference on the Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), in the early hours of last Friday, the conference was forced to reopen after Sen. Scott Brown and others expressed their objection to the last minute insertion of a $19 billion financial services tax that would have offset the costs of the bill. After removing the tax entirely (see below for a full explanation), and despite concerns about other provisions (e.g. derivatives, also discussed below), the conference again came to a close again on Wednesday. The House of Representatives passed the measure on Thursday, July 1st. However, due to the long 4th of July recess, and questions about whether there are 60 votes to defeat a Republican filibuster, the Senate pushed back consideration of the bill to the week of July 12th.

Although the passing of Sen. Byrd and the wavering support by Brown delayed the Senate consideration, it now appears all but certain that Senate Majority Leader Reid will have the votes to cut off debate on the bill. Sen. Cantwell, along with moderate Republicans including Senators Snowe and Collins, has expressed interest in voting for cloture (allowing floor debate to end for the bill to come to a final vote), but then possibly voting against the bill itself. Interestingly, it is only a procedural vote in this instance that needs the 60 votes; final approval of Dodd-Frank only requires a simple majority.

Even after the Senate passes the bill and President Obama signs it into law, the real work will begin as relevant regulators including the Commodity Futures Trading Commission (CFTC), Securities and Exchange Commission (SEC), Systemic Risk Council and the Consumer Financial Protection Bureau ("CFPB") (of which the latter two are created by Dodd-Frank) commence crafting the plethora of rules created in the 2,000-page bill. Although many broad issue areas were framed by Dodd-Frank, the details (in most cases) were left to the regulators. Although most attention has been paid to questions about Volcker and OTC derivatives, the bill leaves at least 355 potential new rulemakings, 47 studies and 74 reports to be carried out. In addition to lawmakers engaging further in the rulemaking process, we fully anticipate and are hearing that a technical corrections bill is already in the works.

LAST-MINUTE CHANGES TO DODD-FRANK CAUSE REAL HEADACH FOR DODD AND FRANK

In the wee hours of last Friday, the House-Senate conference committee added a $19 billion tax on large banks and hedge funds in order to offset the regulatory costs of the bill and comply with House "pay-go" rules. The provision would have authorized the FDIC to levy a new assessment on financial institutions

with more than $50 billion in assets and hedge funds with more than $10 billion in assets. Though it seemed that the bill was on its way to the full House for floor debate and was anticipated to pass, the political realities of the Senate required Dodd and Frank to reconvene the conference.

In the end, in lieu of the $19 billion bank levy, the conference committee agreed to accelerate the termination of the Troubled Asset Relief Program (TARP), which effectively reduced the total amount of TARP's spending authority from $700 billion to $475 billion. The committee also agreed to put higher assessments on large banks for deposit insurance – the bill will now require the minimum level for the Deposit Insurance Fund to increase from 1.15% to 1.35% of insured deposits for the largest banks.

After making this modification, the Dodd-Frank Wall Street Reform and Consumer Protection Act passed the House of Representative on Wednesday by a vote of 237-192, which was more affirmative votes than it received in December 2009 (223-202). This time around, three Republicans supported the bill (Cao, Jones and Castle), while 16 also Democrats (Halvorson, Hill, Kucinich, Ortiz, Schrader, Space, Supak, Teague, Visclosky, Baldwin, Lofgren, Lynch, Moran, Oberstar, Rangel and Slaughter) joined in the affirmative. Interestingly, only three Democrats (Childers, Cooper and Owens) switched to a "no" vote, joining 16 of their colleagues (Berry, Boren, Boucher, Bright, Chandler, Critz, Cuellar, Davis, Edwards, Kaptur, Kirkpatrick, McIntyre, Mitchell, Perriello, Ross and Skelton) in opposing the bill.

DODD-FRANK: HOW IT WILL IMPACT THE FINANCIAL SERVICES INDUSTRY

As some insiders have noted, the Dodd-Frank bill does not compare to the Glass-Steagall legislation enacted in the 1930's in response to the stock market crash and Great Depression. Rather than setting up a "formidable barrier" as Glass-Steagall did, the Dodd-Frank bill will enact a variety of prohibitions and exemptions that vary depending on the kind of financial institution in question.

Broadly speaking, large financial groups whose failure would put the entire economy at risk will have to set aside more capital and cut back on risk. The amount of capital will be determined in the coming month, and international and domestic regulators will make this ruling as agreement on new standards are made. Securities firms in particular will be targeted by these new regulations, in large part because many in Congress blame the activities of Lehman Brothers and Bear Stearns and their collapse as the "cause" of the financial crisis.

Large banks such as Goldman Sachs and Morgan Stanley will be required to stop trading on their own accounts, cut back on investments in hedge funds and private equity over the next five years, and ensure that their client relationships are free of conflicts of interest. Further, even though these firms became bank holding companies or nationally chartered banks or order to take advantage of federal assistance in 2008-2009, under the so-called "Hotel California" provision, they cannot revert back to their prior status to avoid these regulations. In sum, the new rules will have a significant effect on how the two financial behemoths run their businesses.

Large firms in general will be allowed to retain the bulk of their derivatives trading, but those transactions backed by equities, commodities, and junk credit default swaps will be required to exist in a separate subsidiary with higher capital requirements. The exact conditions on these subsidiaries are yet to be

determined, but it appears that the three largest derivative firms – JPMorgan Chase, Citigroup and Bank of America – will be required to spin off about 30% of their derivatives-trading business. Though substantial, the new mandates are considerably more lenient than the changes championed by Sen. Blanche Lincoln.

In addition to shifting some derivatives trading, firms will also have to make these previously-opaque transactions transparent, with the exception of certain "end-users." New derivatives transactions will be subject to regulatory oversight, and will have to be standardized, cleared and traded on exchanges. Swaps that don't meet the criteria for the new requirements will also be subject to higher capital requirements, which have yet to be fully fleshed out, and which are the subject of some confusion. Sen. Saxby Chambliss has been particularly outspoken against the lack of an explicit end-user exemption in the bill. He had introduced an amendment in the House-Senate conference that was voted down, and would have exempted corporate end-users from margin requirements on certain over-the-counter derivatives transactions.

However, Chambliss' amendment was not added and as a result, the International Swaps and Derivatives Association (ISDA) is reporting that U.S. issuers could be subject to as much as $1 trillion in capital and liquidity requirements. ISDA estimates corporations and other end users could be required to post with their dealer counterparties approximately $400 billion in collateral to cover their current exposure, and an additional $370 billion in credit capacity to cover potential future exposure on certain OTC derivatives transactions. In response to these concerns, Senators Dodd and Lincoln sent a letter to the House in advance of the vote on Wednesday in an attempt to clarify how the capital requirements for end-users would work and stating that regulators would not be allowed to impose capital requirements on traders who use derivatives solely to hedge risk. They also elucidated that margin requirements in the financial reform bill would only apply to *prospective* derivatives contracts, and would not apply to pre-existing ones.

Small banks, on the other hand, stand to gain from the financial reform legislation – the president of the Independent Community Bankers of America was quoted as saying that "we won more than we lost." Certain provisions in the bill would reduce FDIC premiums that small banks pay, would exempt them from parts of the Consumer Finance Protection Bureau, and would reduce their financial exposure to some mortgages by allowing them to sell the loans to investors. Additionally, small banks would be allowed to count certain types of securities toward capital requirements that are not permitted for larger banks.

REG REFORM TO INCLUDE BAN ON MOVIE FUTURES

In a big win for the Motion Picture Association of America (MPAA) and most of Hollywood, the financial reform conference committee voted to retain Sen. Lincoln's language banning futures contracts on box office receipts. As recently as Monday, the CFTC had announced a narrow decision that would have allowed the Cantor Futures Exchange to trade a derivative based on the motion picture *The Expendables*. Though the CFTC found this contract to not be in violation of the Commodity Exchange Act, reg reform conferees bowed to pressure from the movie industry to quash the new investment market before it even began.

The movie futures contracts were intended to allow film investors to hedge their financial commitment, but key players in Hollywood objected to the concept because of its potential to give shorting investors an incentive to sabotage a project.

EU TO PASS TOUGH BONUS RESTRICTIONS

On Wednesday, EU legislators and member-states approved unprecedented restrictions on bankers' bonuses, and this legislation is expected to become law in the European Parliament this week. The new law would require that 40-60% of bonuses be deferred for 3-5 years and half the upfront bonus would have to be paid in shares or other securities linked to the employer bank's performance. The cash portion of the bonus would be restricted to 20-30%, which is much stricter than any rules currently in place in individual EU states.

Bankers and regulators were caught off guard by the approved rules, though UK officials stated that they were aligned with recommendations made by the G20 and Basel. National regulators would have some discretion in applying the new rules in their individual countries, but the baseline percentages would remain the same through Europe. Additionally, banks that are bailed out by taxpayers will be required to first rebuild their capital and repay the bailout money, before focusing on employee compensation. Although EU officials welcome the changes because they will "end incentives for excessive risk-taking," bankers expressed concern that the new law could drive business to Asia and the U.S.

SEC CONSIDERS EXPANDING ITS CIRCUIT BREAKER PROGRAM

The SEC released a statement earlier this week that the recently-adopted circuit breaker program would be broadened to include all stocks in the Russell 1000 Index and certain exchange-traded funds. Currently, the pilot circuit breaker program only applies to stocks listed in the S&P 500 Index, and is scheduled to run through December 10th. The program allows for a five minute halt in trading if any relevant security experiences a 10% price change over the preceding five minutes, which allows markets to establish a reasonable market price and resume trading in a "fair and orderly fashion."

Russell 1000 securities are listed on the Russell website, and the SEC will be making a list of included exchange-traded funds on its own website. The SEC is continuing to study and consider a variety of other proposed solutions in its efforts to determine the cause of and prevent another May 6th stock dip.

BIS URGES COMPLETION OF GLOBAL REG REFORM

Earlier this week, the Bank for International Settlements (BIS) warned that governments of industrialized countries must complete reform of the global banking and financial regulatory structure or risk a repeat of the 2008 financial crisis. Some critics have posited that capital requirements proposed by the Basel Committee on Banking Supervision would undermine worldwide economic recovery, but BIS counters that reforms to the financial system will provide the most immediate protection to the economy in the event of a new crisis. BIS also stated that acting now to increase capital and liquidity will make financial institutions sounder and promote a sustainable recovery, which is necessary because "we have hardly any room [to] maneuver" and "macroeconomic policy is in a vastly worse position than it was three years ago."

BIS stressed the importance of the need for macro policies to ensure that all systemically important financial institutions come under review. Beyond reform, BIS also stated the importance of removing support measures for banks, reducing government deficits, and raising interest rates to stem the flow of cheap money for financial speculation and risk.

One critic, the Institute of International Finance (IIF – a global association of the world's leading banks), asserted that the reform package unveiled by the Basel Committee last December ("Basel III"), had the potential to require banks to raise $700 billion in common equity and issue $5.4 trillion in long-term debt over the next 5 years, which would reduce growth in industrialized countries by 3%. Basel Committee officials dismissed the estimates as an unrealistic worst-case scenario.

UPCOMING HEARINGS

Due to the July 4th Congressional recess, there are no upcoming financial services hearings in the House or Senate.