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FINANCIAL SERVICES REGULATORY REFORM UPDATE

Pre-Conference Update

At 2:15pm on Thursday, June 10th, the House and Senate will be initiating the formal conference process to reconcile the differences between its respective versions of H.R. 4173, the Wall Street Reform and Consumer Protection Act. We wanted to alert you to the following provisions of the legislation where the most significant debate is likely to occur.

The Conference

Senate Majority Leader Reid named the Senate's twelve conferees (seven Democrats and five Republicans) before leaving for the Memorial Day Recess. Although initially it appeared as if House Speaker Pelosi was going to name about thirteen conferees, on Wednesday June 9th, she named thirty-one members of the house (20 Democrats and 11 Republicans) to the conference. House Financial Services Chair Frank (D-MA), who will be Chairman of the conference committee, has asserted his intention to make this "the most open conference in recent memory," and C-SPAN is going to televise the formal proceedings.

Named Senate conferees are Senators Chris Dodd (D-CT), Charles Schumer (D-NY), Jack Reed (D-RI), Tim Johnson (D-SD), Tom Harkin (D-IA), Patrick Leahy (D-VT), Blanche Lincoln (D-AR), Richard Shelby (R-AL), Bob Corker (R-TN), Mike Crapo (R-ID), Judd Gregg (R-NH), and Saxby Chambliss (R-GA). Named House conferees Barney Frank (D-MA), Paul Kanjorski (D-PA), Maxine Waters (D-CA), Carolyn Maloney (D-NY), Luis Gutierrez (D-IL), Mel Watt (D-NC), Chair, Gregory Meeks (D-NY), Dennis Moore (D-KS), Mary Jo Kilroy (D-OH),Gary Peters (D-MI), Rep. Spencer Bachus (R-AL), Rep. Joe Barton (R-TX), Rep. Sam Graves (R-MO), Rep. Darrell Issa (R-CA), Rep. Frank Lucas (R-OK), Rep. Lamar Smith (R-TX), Rep. Ed Royce (R-CA), Rep. Judy Biggert (R-IL), Rep. Shelley Moore Capito (R-WV), Rep. Jeb Hensarling (R-TX) and Rep. Scott Garrett (R-NJ). In addition, Speaker Pelosi named the following conferees only for the specific portions of the legislation on which their committees have jurisdiction: Collin Peterson (DFL-MN) and Leonard Boswell (D-IA) (Agriculture), Henry Waxman (D-CA) and Bobby Rush (D-IL) (Energy and Commerce), John Conyers (D-IL), and Howard Berman (D-CA) (Judiciary), Ed Towns (D-NY) and Elijah Cummings (D-MD) (Oversight and Government Reform), Nydia Velazquez (D-NY) and Heath Shuler (D-NC) (Small Business Committee).

The conference process should move relatively quickly, if the time frame released by Chairman Frank holds. According to his memo, the conference will commence with organizational meetings and opening statements by the members this Thursday, and then meetings and votes on the substantive issues from

June 15-23. The Administration is pushing for a final bill before President Obama's scheduled departure for the G-20 Summit in Toronto on June 24th, and Chairman Frank has indicated that he intends to reach a consensus by then. Because of procedural issues, both the House and Senate will need a few additional days before they can approve the conference report so it is likely that the President will likely have to wait until July 4th before he can sign the bill into law.

Because of the considerable overlap between the two bills, an overwhelming majority of the legislation is expected to be reconciled without fanfare, much of which has already occurred at a staff level in what is known on Capitol Hill as a "pre-conference." However, there are some significantly controversial provisions within the legislation, which have the potential to substantially impact the financial services industry as well as the general business community. The following is a summary of the issues of which we think you should be most aware:

Derivatives

One of the issues that have garnered the most publicity in the lead-up to the conference is federal regulation of the over-the-counter derivatives market.

While most of the focus has been on Senate Agriculture Committee Chair Lincoln's infamous "Section 716" language (requiring bank holding companies to spin off their swaps desks), there are other derivatives-related issues that also stand to have a significant impact. The definition of "major swap participant" is the first point of contention, with the Senate bill taking a much broader view as to which entities are subject to regulation. Secondly, the ultimate definition of "commercial end users" (*i.e.,* entities that will be exempt from the law's clearing requirements), still needs to be resolved because the House bill contains much broader exemption language than the Senate. Additionally, the Senate bill establishes a fiduciary duty for swap participants dealing with certain customers (e.g. states, municipalities, pension funds), and the conferees will have to decide whether or not to include this duty in the final legislation.

Up to this point, rumors abounded that the strict Section 716 spin-off language would be taken off the table after Sen. Lincoln's primary election was resolved on June 8, and at every other stage in the process as well. Lincoln surprised many pundits by winning her run-off on Tuesday night, and how her presence as a non-lame duck member of the conference impacts the calculus on this provision remains to be determined.

Generally speaking, we see the conference facing an "either, or" option between Lincoln's swaps language and the more restrictive version of the Volcker rule known as "Merkley-Levin" (see below), which bans proprietary trading, including swaps, by bank holding companies. That said, the conference is an often convoluted process and nothing should be taken for granted until the final report is presented.

Volcker Rule / Merkley-Levin Proprietary Trading Ban:

The Senate version of the bill contains the so-called "Volcker Rule," named after former Federal Reserve Chairman Paul Volcker. If enacted, the provision would prohibit bank holding companies from engaging in proprietary trading, sponsoring a hedge fund or a private equity entity. As drafted, the rule would be subject to a 6-month study, followed by a period of at least nine months for administrative regulation-writing. The regulations would then have at least two years before full implementation, with the potential for up to three additional years of delay. Regardless of this drawn-out framework, Wall Street has made defeating the Volcker rule one of its top priorities.

No similar ban exists in the House version of the bill, particularly because the White House and Paul Volcker announced their support for the policy after the House had already passed its version of the legislation. However, there is language in the House bill that would allow the Federal Reserve to prohibit proprietary trading by a systemically important financial company – including a non-bank financial company – if the Fed determines that such trading poses a threat to U.S. financial stability. The Senate bill does not extend its ban to non-banks, but rather requires the Fed to adopt rules imposing additional capital requirements and limits for systemically important non-bank financial companies that engage in proprietary trading or sponsoring and investing in hedge funds and private equity funds.

Despite the fact that Chairman Frank, Chairman Dodd and the White House have all publicly announced their support for the Volker Rule, there are some members of the Senate, lead by Senators Merkley (D-OR) and Levin (D-MI) who will be working behind the scenes of the conference to push their more restrictive and expansive prohibition on proprietary trading. The so-called Merkley-Levin amendment, which was never voted on by the Senate during its consideration of the regulatory reform bill, would go further than the Volcker Rule in allowing regulators to expand the definition of prohibited activities that constitute proprietary trading and would effectively limit FDIC insured institutions from using customers deposits for any proprietary trading.

Finally, even if opponents of the Merkley-Levin proposal are not able to beat back efforts to get the bill into the conference report, opponents of a proprietary trading ban will attempt to weaken any regulation that is pushed forward by explicitly creating an exemption for insurance companies. In doing so, the conferees will be asked to follow a Senate motion (passed by a vote of 87-4) instructing the conferees to ensure that proprietary trading restrictions do not prevent insurance company affiliates of depository institutions from engaging in such trading in the ordinary course of business.

Interchange Fees

The interchange or "swipe fees" provision in the Senate bill, which was added as a floor amendment by Senator Durbin (D-IL), would require the Federal Reserve to determine what a reasonable and proportional interchange fee is on debit transactions for issuers with over $10 billion in assets. The language also allows merchants to provide consumers discounts for cash transactions, to set minimum and maximum transaction amounts, and to discount for a merchant's use of certain networks. Although the big banks are adamant about removing this provision from the final version of the legislation, it could be an exceptionally difficult task because eight of the twelve Senate conferees voted for this provision on the floor. In an effort to be realistic about whether the provision can be completely removed, opponents are pushing to expand what costs the Fed can consider in making their analysis of what is "reasonable and proportional." Although this provision is generally thought only to impact Visa, MasterCard and the biggest banks, the community banks are actively engaged in lobbying on this issue as well. Reportedly, these smaller banks are advocating for language that protects their networks from reductions in interchange income.

Investor Protections:

Substantial portions of the legislation are devoted to "improving investor protections," an amorphous catch-all that includes a range of provisions amending the federal securities laws, from registration of hedge funds and other private investment vehicles to how credit agencies are regulated. Among these, we wanted to call your attention to the following:

Fiduciary Standard for Broker/Dealers

The House-passed version set specific requirements for the Securities and Exchange Commission ("SEC") to adopt rules specifying that the standard of conduct for broker-dealers must be the same as the standard of conduct for investment advisers when providing personalized investment advice to a retail customer about securities. The Senate bill did not contain this requirement, instead only requiring the SEC to "study the effectiveness of existing standards of care for broker-dealers and investment advisers for providing personalized investment advice and recommendations about securities to retail customers." In the event that the study concludes that there are gaps in the duty, or that overlaps exist, then the SEC would be required to promulgate rules under its existing statutory authority within 2 years of the date enactment of the Regulatory Reform bill.

Additionally, both the House and Senate bills authorize the Public Company Accounting Oversight Board (PCAOB) to review auditors of registered broker-dealers and permit the PCAOB to refer investigations, as well as release documents and information gathered in those investigations, to a registered broker-dealer's self regulatory organization (SRO).

There are significant pushes for the removal of both the House and Senate provisions, but given the likely populist views of several key members of the Conference Committee, it is unlikely that the provision would be struck entirely.

Hedge Fund Registration

Although both the House and Senate versions of the bill place new registration requirements on advisers to hedge funds (*e.g.*, through the elimination of both the private investment adviser and intrastate registration exemptions), only the House-passed bill contains language permitting the SEC to issue rules requiring the registration and examination of investment advisers to "mid-sized private funds" that "reflect the level of systemic risk posed by such funds." It is important to note that the term "mid-sized private funds" is not defined in the bill, though both bills require at least $100 million dollars under management to trigger these registration requirements. Additionally, the bills expand the ability of the SEC to regulate private funds advised by a registered investment adviser, by requiring the adviser to maintain or file with the SEC records detailing various aspects of the fund's assets. These aspects include assets under management; use of leverage, (including off-balance sheet leverage); counterparty credit risk exposure; trading and investment positions; trading practices. The bills would also provide the SEC and the Federal Reserve broad authority to request any other information deemed necessary to assess systemic risk.

Executive Compensation

In response to public and shareholder outrage over salaries of executives at TARP fund recipients, both the House and Senate bills focus heavily on executive compensation in their corporate governance sections. Both chambers included a "say-on-pay" provision that would require companies to provide their shareholders with an annual non-binding vote to approve the compensation of executives as disclosed pursuant to the SEC rules. The House, but not the Senate, would also require a non-binding vote on "golden parachute" compensation. Critics of the say-on-pay provision warn that it would give an undue amount of power to proxy advisory firms, which also provide consulting services to the same companies they are assessing when making their proxy vote recommendations.

Both bills would also require the SEC to direct securities exchanges to include a listing requirement that executive compensation be set by "independent directors."

The Senate bill includes a clawback provision, but the House version does not. These terms would strengthen Sarbanes-Oxley Section 304, which require the rescission of incentive-based executive compensation in the event of an accounting restatement due to material noncompliance with financial reporting requirements, even if there is no misconduct. The Senate bill would require clawback of any amounts paid based on overstated results for the three years prior to the restatement, and compensation would be calibrated to the executive's restated performance.

The Senate bill has its own "pay and performance" and "internal pay equity" disclosure requirements that are not found in the House bill and would require the SEC to amend Item 402 of Regulation S-K. The former would mandate the disclosure of the relationship between a company's executive compensation and financial performance, taking into account any change in the value of the company's shares, dividends and distributions. The latter would order the disclosure of how median employee compensation compares to CEO compensation.

Corporate Governance

In 2009, the SEC issued a proposed proxy access rulemaking proposal, which underwent extensive notice and comment, but was held in limbo while awaiting congressional clarity and sanction of the agency's authority in this area. This set the stage for the inclusion of proxy access provisions in Congress's financial regulatory reform package, and indeed both bills amend Section 14(a) of the Securities and Exchange Act of 1934 to provide for shareholder access to proxies to nominate directors. The main difference between the two chambers is that the House *requires* the SEC to create rules and regulations granting this access, whereas the Senate merely *authorizes* the SEC to do so. Regardless of which path is taken, the SEC is likely to move forward in enacting proxy access rules. Activists have been pushing for this provision for years, asserting that proxy access would mitigate a lack of management accountability.

Only the Senate bill has a mandate for majority voting in the case of an uncontested director election. Directors who receive less than a majority must tender their resignation, unless the board unanimously votes to decline the resignation. The plurality standard would still apply in the case of a contested election. The Senate, and not the House, would also require a proxy statement explanation of why the positions of

CEO and chairman are separate or combined. The Senate bill would authorize the SEC to prohibit listing on a U.S. exchange of any public companies failing to comply with the corporate governance standards set forth in the legislation.

Generally speaking, the financial regulatory reform proposals on corporate governance represent a shift towards federal oversight and authority over formerly state law governance issues.

Credit Rating Agencies

Credit rating agencies are under scrutiny for their role in the financial crisis, as is evidenced by the recent heated Financial Crisis Inquiry Commission hearings and key provisions in both the House and Senate bills. The two chambers reached similar conclusions in how to handle rating agency oversight, with only a couple major differences. For starters, the House bill would require all credit rating agencies to register as nationally recognized statistical rating organizations ("NRSRO's") by filing an application with the SEC. Both bills would create an SEC office of sufficient size to administer rules with respect to rating practices, at least an annual review of each registered/national recognized credit rating agency's methodologies, and greater enforcement tools.

The so-called "Franken Amendment" is unique to the Senate bill, and would require the SEC to establish a Credit Rating Agency Board to assign qualified NRSROs to provide initial ratings to structured finance products, on a rotating basis. Understandably, the major credit rating agencies are up in arms about this almost-guaranteed loss in market share.

Both bills would require credit rating agencies/NRSRO's to have a board of directors, with at least one half (Senate) or one third (House) comprised of independent directors. The board's oversight would be the same in the Senate and House bills, as with a mandate for the designation of a compliance officer and an annual securities law compliance report. Both bills create a private right of action, with the House requiring a "grossly negligent" rating as a substantial factor for the investor's economic loss, and the Senate necessitating a "knowing or reckless" failure of the rating agency to conduct a reasonable investigation of a rated security. The House bill puts forth a comprehensive mandate for conflict of interest policies and procedures, whereas the Senate has a much narrower provision. Both bills also go into substantial detail on obligating the SEC to issue rules for credit rating agencies to ensure that their methodologies are legitimate and that users have proper notification of their procedures.

Overall, with the passage of these provisions, credit rating agencies will be subject to increased oversight by the SEC, accountability and liability language, conflict of interest protections, and transparency requirements.

Other Issues:

Initially, the creation of a resolution trust fund in the House bill stirred up quite a bit of controversy, but it now appears that the Senate's approach to dismantling troubled firms will be favored. The House would have created a fund from risk-based assessments on large financial companies with $50 billion or more in assets. Instead, the Senate version will have the FDIC borrow from the Treasury to wind down systemically risky institutions, and the loan would be repaid by assessments on claimants who benefited from the liquidation. Only if a shortfall remained would there be assessments on those institutions with $50 billion or more in assets.

Finally, an issue that is flying under the radar but which could have significant impact on the business community *writ large* is a small provision of the entire bill that would replace the so-called "Magnuson-Moss" procedural protections that currently in place under the Federal Trade Commission Act Administrative Procedure Act ("APA") rulemaking authority. This provision is only in the House version of the legislation.

Under the APA standard, the FTC would have nearly unfettered authority. When combined with an activist regulatory environment, this authority could lead to the FTC's supervision over a large swath of the economy. In addition, the House bill would augment the FTC's enforcement powers in two distinct ways: the ability impose civil penalties on a company for "unfair or deceptive acts or practices" without referral to the Department of Justice (the "DOJ"), and the power to impose third-party liability upon companies that "substantially assist" an unlawful act.

House Energy and Commerce Committee Chairman Henry Waxman (D-CA), who is likely to be on the conference, is a shrewd legislator who has made it clear that he would like to see these changes enacted at the FTC. Although the "Mag-Moss" issue is a discrete and somewhat arcane provision, without Senator Rockefeller (D-WV, Chairman of the Senate Committee with jurisdiction over the FTC), on the conference committee, we believe that political realities (*i.e.,* the need to ensure that the conference report can get 60 votes in the Senate) will likely prevent this change from going through.

Conclusion:

Given the compressed timeframe, and the prevailing populist and anti-Wall Street mood in the country, it is difficult to predict how any provision will ultimately look at the end of the conference. The White House plans to play a prominent, though unofficial role in the conference process, and behind-the-scenes maneuvering and deal-making have the potential for surprise inclusions and deletions in the final regulatory reform package. One thing that has become certain, that unlike the uncertainty surrounding the battle over health care reform, there *will*, barring unforeseeable changes in circumstances, be a financial regulatory reform bill signed into law by President Obama this summer.

Comparatively speaking, the U.S. federal government will be taking a back-end approach in its increasing regulatory role in the financial services industry, unlike international counterparts who are more focused on breaking up big banks to head off the "too big to fail" issues from the get-go. Some argue that legislators on both sides of the aisle are taking a "wimpy" approach to real reform because of mid-term elections looming this November. Others argue that too much change and regulation could be detrimental to an already unstable economy that is desperately in need of willing investors and credit. And still others will say that no matter how the financial regulatory reform package looks in the end, there will always be loopholes to exploit and other parts of the world with less-stringent regulation.

Regardless, Thursday's Conference Committee opening statements should kick off an exciting couple weeks in Washington, as the entire world tunes in to understand how the U.S. will respond to the world financial crisis since the Great Depression.