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FINANCIAL SERVICES REGULATORY REFORM UPDATE

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Although the calendars turned from August to September two weeks ago, the combination of a "late" Labor Day and the Jewish New Year, means that Congress is just coming back to Washington, DC this week. This update provides a look back at the major events from the August recess and examines how they will impact activities in the fall and beyond.

Returning members of Congress and their staff find themselves looking at about three weeks left in the legislative calendar and just under two months until the mid term elections. During the next three weeks we don't anticipate any major legislation - financial services related or otherwise -- getting passed. Two exemptions could be the small business lending bill or legislation to extend the Bush tax cuts, but with Republicans eyeing momentous victories in November, there is little appetite to work with Democrats to give the majority a victory in advance of the mid-term elections.

However, the absence of any meaningful legislation being passed does not mean it will be a quiet three weeks in Congress. During this time we will see several financial services items on the table. Perhaps most notably will be the beginnings of federal housing finance reform, which was conspicuously left out of Dodd-Frank Wall Street Reform and Consumer Protection Act, as the House Financial Services Committee has scheduled two hearings on the topic in September. Additionally, hearings are already planned (see below) to examine portions of regulatory reform that have already passed into law that either need clarification or justification at this point in the process - before they have even been implemented. Whether these hearings provide the foundation for a much ballyhooed "Technical Corrections bill" remains to be seen, though it continues to seem that K Street, more than members of Congress or the Administration are pushing for such action.

During the next couple of weeks, if not through the end of the year, expect most of the action to come from the Administration. From the highly anticipated announcement of the Director of the Consumer Financial Protection Bureau ("CFPB") to the near continuous rolling out of the hundreds of rulemakings required by Dodd-Frank, the uncertainty surrounding control of the Congress in 2011 and 2012, the balance of activity will continue to drift towards the Administration.

DODD-FRANK: THE AFTERMATH

While the full impact of the legislation may not be felt for years, there was one sector of the industry that faced a near immediate impact, the force of which necessitated emergency intervention by its regulator to restore sanity to the market. This refers, of course, to the credit rating agencies, which among other things now face increased exposure to liability, and may even have to change their treatment of client information in a way that would impact the cost of ratings and the agencies' relationships with securities issuers. Because operative sections of Dodd-Frank went into effect immediately and because of the impact on the day-to-day businesses of so many who rely on the credit agencies, the SEC was forced to issue a no-action letter, essentially allowing issuers a transition period of about 6 months for agencies to comply. Additional requirements might also spring up, upon the completion of studies mandated by Dodd-Frank that examine whether rating agencies should be required to use standardized terminology, whether agency compensation practices should be changed, and whether industry ethical and competency standards should be developed for analysts who help create credit ratings.

Perhaps most notably, Dodd-Frank makes clear that ratings agencies may not be held liable for their ratings opinions, which is a direct reflection of the view held by many members that rating agencies are at least partially responsible for the severity of the financial crisis because of their inflated ratings of certain securities. As a result, Moody's Investors Services Inc. has changed the terms of its contractual agreement with debt securities issuers to include new language requiring issuers to indemnify the rating agency from "any claims of whatever nature… arising from or in connection with this Application and Fee Schedule."

Dodd-Frank creates numerous new requirements for credit rating agencies, and also strengthens the SEC's authority over these firms and even former employees. The SEC will have a new Office of Credit Ratings, led by a director appointed by the SEC chair, and with the mission of administering rules applicable to rating agencies, promoting improved ratings accuracy, and ensuring ratings are not unduly influenced by conflicts of interest. The Office will conduct annual examinations of agencies and "should" publicly disseminate the results. The agencies themselves will also be required to maintain internal controls that govern the implementation of policies, procedures and methodologies for determining their ratings, and in some cases will be compelled to file an annual report.

Additionally, "major structural change" is expected in the development and treatment of retail financial products, as the Consumer Financial Protection Bureau (CFPB) created under Dodd-Frank and its broad authority is established. In addition to its extensive regulatory powers, the CFPB will also have the ability to implement its mandates at an accelerated pace. Up to now, new standards had to be vetted by congressional committees, passed by both chambers of Congress, and potentially go through a conference process. After passage, federal agencies would then have to propose, evaluate and finalize rules to implement the law, all of which could take years. Now the process will be much more streamlined and will have much less opportunity for slowing, shaping and changing new efforts to regulate financial institutions. The CFPB will handle many regulatory issues on its own going forward, with the approval of its director as the only necessary stopgap. The newly-created systemic risk council will have the ability to overturn CFPB rules, but must meet a high threshold to do so - experts only expect the council to turn over CFPB rules in the rarest of circumstances.

Namely, the CFPB will have the power to address unfair or deceptive acts and practices (UDAP) in federal financial institutions with over $10 billion in assets, marking the first time this authority has been consolidated all in one regulator. In addition to UDAP, Dodd-Frank also allows the CFPB to address practices it deems abusive. Industry experts state that this will comprise many practices including those that are "immoral, unethical, oppressive or unscrupulous," which reverts back to the unconscionability standard of decades past. Dodd-Frank also gives the CFPB a range of remedies from which to choose, including some as high as $1 million per day, for knowing violations of the law or the regulations.

Some are concerned that the new "fairness" standard under Dodd-Frank is too nebulous, and more guidance will be needed on want amounts to a UDAP violation, even after the CFPB issues regulations. For instance, state attorney generals have explicit authority under Dodd-Frank to file civil actions to enforce Title 10 of the legislation (the section creating the CFPB and mandating new consumer protection provisions), which would subject some financial firms to both federal and state claims. State attorneys general are also free to act on alleged violations of CFPB regulations by federal institutions, so long as they provide notice to the CFPB and the institution's prudential regulator.

Similarly, the FDIC will also be creating new "fairness" standards, and recently asked for comment on proposed guidance regarding overdraft payments. The agency said it will "take supervisory action where these programs pose unacceptable safety and soundness or compliance management system risks or result in violations of laws or regulations…" Comments will be accepted through September 27th, and at least one industry organization is already concerned that the proposed guidance would be hard to put into practice and is an example of regulators trying to "force banks to shove preferred product options in consumers' faces."

However, the most pressing question regarding the CFPB is whom the President will appoint as its director. This decision has obvious impacts on the imprint of the Bureau, but additionally, although many of the new Bureau's functions will not go into effect until 2011, this timing is based on a "designated transfer date" on which federal regulators must move their consumer protection functions to the CFPB. Treasury Secretary Timothy Geithner will be determining this date, and has stated that he might do so as soon as mid-September. Is not clear whether a delay in naming the director will impact that transfer date -- though representatives from all impacted agencies have been meeting for months to work out the transfer. Obviously, having a director in place would ease that transition.

WARREN CONTINUES TO BE CFPB FRONTRUNNER

White House Secretary Robert Gibbs stated on Thursday that the President will be appointing the new CFPB director in the very near future. All signs continue to point to Harvard Law School professor Elizabeth Warren, and in fact she met with President Obama this past Tuesday. Gibbs told reporters that Warren would be a "highly qualified candidate to join this administration to help implement financial reform," but that the President is also considering other candidates, including Assistant Treasury Secretary Michael Barr. The White House did not say whether Barr also met with the President to discuss the position, and some say he is the likely frontrunner for another DC position - heading the Office of the Comptroller of the Currency.

Warren helped develop the concept of the consumer protection agency, and gained notoriety by chairing the Congressional Oversight Panel monitoring the 2008 financial industry bailout. It remains unclear whether she would have the support of a sufficient number of Senators, or even the support of all 59 Democrats in that chamber. There is some speculation that President Obama would make a recess appointment to avoid a bruising confirmation battle, where unified Democrat support is not guaranteed (for example Senate Ben Nelson has been very public in his concerns about Warren). One option would be to nominate Warren right before Congress breaks for the mid-term elections (which would rally the base) and then have the nomination hearing during the lame duck session when it may not receive as much political scrutiny or there is a better chance for a deal to be cut.

SEC APPROVES PROXY ACCESS RULES

At the end of last month, the SEC voted (3-2, along party lines) to approve rule amendments that would allow shareholders, individually or in a group, to have their director candidates included in corporate proxy materials if the shareholders continuously owned at least 3% of the public company's voting stock over the last 3 years. Small issuers will be exempt from the new rules' application for 3 years, and companies will be required to include disclosure about the nominating shareholder and shareholder candidate in their proxy materials. These rules are only applicable in states that allow for proxy access, but SEC staff stated that they were not aware of any states that bar proxy access. SEC Chair Schapiro noted that the new rules are the result of "long and careful consideration of the often widely divergent views" of commenters, the SEC and its staff.

Although institutional investors were happy with the new rules (because they are the most likely beneficiaries of proxy access rules), the business community raised its concerns with added costs and the threat of activists in boardrooms. Legal challenges are expected, because for example, no theory or data adequately substantiate the SEC's imposition of the mandatory proxy access right, according to one legal expert. Some litigation might also ensue upon the implementation of the new rules, with regard to whether shareholders meet share eligibility requirements and whether candidates live up to their certification that they were not seeking control of the company.

BASEL COMMITTEE WORKING TOWARDS GLOBAL CONSENSUS

The Basel Committee on Banking Supervision will be meeting several times this month to finalize a few important elements of the Basel III financial regulatory reform package. These meetings will address minimum capital set-aside requirements and proposed capital buffers, among other issues. Leaders from the U.S., France, Germany and Japan (27 countries are represented in all) are involved in these negotiations, creating much higher stakes for what might otherwise be deemed a mere technocratic exercise. The aim is for a final package to be completed in time for the G-20 summit in Seoul on November 11-12.

Most recently, the Basel Committee agreed on Sunday to a new set of requirements that will more than triple the amount of capital banks must hold in reserve – one of the provisions would require banks to raise their leverage ratios by increasing common equity from 2% of assets to 7%. Some banks are already arguing that these new rules could reduce profits and raise the cost of borrowing, but regulators on the Basel Committee have countered that the agreements will contribute to long-term financial stability and growth. Additionally, banks will have as long as a decade to phase in some of the most strident rules, and some officials added that some capital increase proposals could have been substantially more and with quicker implementation deadlines. Regulators noted that they might still impose stricter rules on "systemically important" banks.

Federal Reserve Chair Ben Bernanke was present for the weekend negotiations, and his agency, the FDIC, and the Office of the Comptroller of the Currency issued a joint statement afterwards stating that the accord "represents a significant step forward in reducing the incidence and severity of future financial crises." The United States is expected to codify the Basel III reforms, but there is potential for other countries to water down the regulations before enacting them.

The agreed-upon provisions are subject to approval by the G-20 nations in November, and then must be enacted by the individual nations before they become compulsory. The Basel Committee set a deadline for January 1, 2013 to accomplish all this and begin phasing in new rules.

In a speech delivered on September 3rd, Basel Committee Chair Nout Wellink stated the importance of reaching an agreement on the Basel III package of revised capital set-aside rules. He specifically said there are "clear economic benefits from increasing the minimum capital and liquidity requirements from their current levels" for both developing countries and those hit hard by the financial crisis. He added that the benefits of these increased set-asides "substantially exceed" the potential costs," and warned that we cannot afford to "operate with such thin minimum regulatory" requirements because governments don't have the will or the means to organize further bank bailouts.

In a study released last month by the Basel Committee and the Financial Stability Board, it was found that stronger capital and liquidity requirements would likely "have a modest impact on aggregate output," reducing global economy growth by 0.04% per year over a 4.5 year period. However, the same study also found that raising the capital ratio by 1% from its average pre-crisis level and simultaneously increasing liquidity standards would cut the probability of future financial crisis in about half. This would produce an estimated benefit of 1.6% of global economic growth.

A Credit Suisse analysts' report was also released at the end of last month, which found that recent changes made to the Basel III proposal on minimum capital requirements for banks would significantly reduce the estimated cost of the proposal to the European banking sector. Initially the figure was projected at 244 billion euros, but this has now dropped to 149 billion euros - a "savings" equivalent to 11% of the European banking sector's market capitalization. European banks have been some of the most critical of the Basel III proposals because they believe they have a much bigger negative impact than competing banks in North America and Asia. As a result, the Basel Committee bent under pressure to amend some of its minimum capital set-aside requirements and provide longer phase-in periods for implementing the changes.

Additionally, the Basel Committee stated that the implementation of a proposed leverage ratio and a proposed Net Stable Funding Ratio could be delayed until 2018.

MEMBERS ADDRESS CONCERNS WITH SEC POLICIES

Last week, Senator Chuck Schumer, a member of the Senate Banking Committee, sent a letter to the SEC, urging Chair Schapiro to consider new rules that would "slow down" high-frequency trading (HFT) during periods of high market volatility. The Senator also proposed limits on certain techniques that are used by high-frequency traders that may have contributed to the flash crash on May 6th. Schumer acknowledged that HFT and technological advances have brought "significant efficiency gains" to the market, but that he now believes the costs have come to outweigh the benefits, specifically with regard to long-term investors.

Rather than resorting to circuit breakers, as the SEC has already proposed, Schumer recommended that the agency use a system of speed bumps to slow the pace of trading activity, rather than shutting it down entirely. Schumer also suggested that the SEC curb "quote stuffing," (which occurs when traders bombard the market with thousands of orders in the space of a second before canceling them), by requiring a minimum duration for any quote. Schumer would also have the SEC consider an outright ban on quotes in increments of less than a penny.

Schumer had also written a letter to the SEC on HFT in August of this year, requesting that the agency place certain HFT firms under a uniform set of rules to prevent them from pulling out of markets in such as fashion as they did during the May 6th flash crash. In that letter, Schumer stated that changing the SEC's 17-year-old definition of "market maker," so as to create more affirmative obligations for high-frequency traders in providing liquidity, would be an effective means of preventing future volatility in the stock market.

Two Republican congressmen, Reps. Spencer Bachus (R-AL) and Jeb Hensarling (R-TX), also sent a letter to SEC Chair Mary Schapiro, asking her to respond to 15 of their questions. Overall, the two congressmen were questioning whether the SEC's recent rule proposal on flash orders and others align with the SEC's statutory mandate to promote "efficiency, competition, and capital formation" in U.S. equity markets. Bachus and Hensarling called recent SEC proposals as "seemingly *ad hoc*" and based on political pressure instead of economic and empirical data. They gave Schapiro until Friday, September 10th to provide answers to questions on whether the SEC analyzed the potential impact of a flash order ban on price transparency, liquidity, and execution quality, and if so, what it concluded.

There were also questions on whether the SEC considered the impact of recent proposals on market liquidity or whether the SEC took into account the unique needs of small capital companies when issuing the proposals. Bachus and Hensarling were particularly concerned that the SEC would rashly seek to curb high-frequency trading in response to the "flash crash" of May 6th, and they added that restrictions on these trades could do "more harm than good" and damage the U.S.'s global reputation. This letter represents the first formal resistance to Democratic policies.

FRANK TO HOLD EXEC COMP HEARING

House Financial Services Committee Chair Barney Frank will be holding a hearing on September 24th on whether regulators are effectively reining in excessive pay practices on Wall Street. Federal regulators have new authority under Dodd-Frank Section 956(b) to prohibit incentive-based pay schemes or "any feature of any such arrangement" that encourage inappropriate risk-taking at financial institutions. The hearing will likely analyze this unprecedented authority, and Republican representatives are expected to prod panelists on the potential for arbitrariness or overreach by regulators in the implementation of this provision.

Wall Street insiders are concerned with the lack of definition of "inappropriate risks" and the fact that the government will be able to regulate the pay of lower-level employees, and not just executives. In fact, during the reconciliation conference between the Senate and House before passage of Dodd-Frank, Frank did concede that this provision could reach "not just the top people."

On a related note, there has also been a large backlash against the new rule forcing U.S. companies to disclose the ratio between the CEO's pay package and that of a typical employee in the company. This has the potential to be a "logistical nightmare" particularly for multinational corporations in calculating the ratio, according to an industry expert. This figure will have to be based on median annual total compensation for all employees, which in practice might be impossible for a large company with tens of thousands of employees around the world. The new rule will also be a boon to activists fighting against excessive executive compensation, because the 2009 average S&P 500 chief executive median pay was $7.5 million, whereas the same figure for the average private sector employee was just over $40,000.

FCIC "TOO BIG TO FAIL" HEARINGS

On Wednesday, September 1st and Thursday, September 2nd, the Financial Crisis Inquiry Commission (FCIC) held public hearings on "Too Big to Fail: Expectations and the Impact of Extraordinary Government Intervention and the Role of Systemic Risk in the Financial Crisis." As a reminder, the FCIC is ten-member commission set up by Congress to investigate the domestic and international causes of the 2008 financial crisis, and has the ability to subpoena documents and witnesses for testimony. On the first day of hearings, there were two panels on Wachovia Corporation and on Lehman Brothers, at which various members of those institutions, the Fed, the FDIC, and the private sector spoke.

Notably, on the first day of hearings, Vice Chair Bill Thomas of the FCIC spoke out against a September 2008 rule change made by the IRS that provided favorable tax treatment for losses held by banks acquired by other financial institutions. This change meant added costs for taxpayers because it expanded deductions available under the Internal Revenue Code, and repealed a 22-year-old law that Congress passed, which Thomas referred to as an "unprecedented executive branch usurpation" of congressional legislative authority. Acquiring banks had the ability to use these losses to offset their own tax liabilities, which is what enabled federal regulators to have Wachovia Corp. rescued by Wells Fargo Corp. Similarly, Sen. Charles Grassley, Ranking Member of the Senate Finance Committee, made a statement in October 2008 that the IRS rule change could cost the federal government billions of dollars, and that Congress should have been consulted.

Although the former Wachovia chair testified that this sale was accomplished without federal assistance, Thomas argued that it was the taxpayers who paid for the IRS change in law, which allowed for no emergency loans by the Fed and no deposit insurance funds by the FDIC to be paid out. Former Wachovia Chair Robert Steel, Fed General Counsil Scott Alvarez and FDIC Acting Deputy Director John Corston all testified that they had no knowledge of the IRS rule change while the transaction was being arranged.

Additionally, as part of the FCIC final report on the causes of the 2008 financial crisis (due on December 15th), Chair Phil Angelides will be publishing a large amount of internal documents from financial institutions and federal agencies involved in the breakdown, much to the chagrin of those organizations. Angelides stated that he would be making this background data available so as to "add to the knowledge of the crisis" and to allow further scrutiny by academics and journalists.

Angelides plans to release a myriad of written material assembled during its inquiry, and also over 500 audio interviews of witnesses, including average Americans, financial institution board members, and federal officials. As the report deadline nears, he has stated that the process of obtaining additional information from Wall Street is somewhat painstaking, and specifically added that the FCIC was "wrestling" with Goldman over disclosure (to which Goldman responded that the commission had led the firm to believe it was satisfied).

Additionally, Rep. Issa (R-CA), has stated his intention to examine potential conflicts of interest among the FCIC commissioners, although Angelides has stated in opposition that "we're not going to be disrupted in getting that job done."

UPCOMING HEARINGS

On Wednesday, September 15th at 9:30am, in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises will hold a hearing on the primary causes of financial losses for Fannie Mae and Freddie Mac and will review progress in improving management at the agencies during the last two years.

On Wednesday, September 15th at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing entitled "Covered Bonds: Potential Uses and Regulatory Issues.

On Wednesday, September 15th at 10am, in 419 Dirksen, the Senate Foreign Relations Committee will hold a hearing entitled "Banking on Reform: Capital Increase Proposals from Multilateral Development Banks."

On Wednesday, September 15th at 10am, in 1100 Longworth, the House Ways and Means Committee will hold a hearing on whether China has made any material progress in allowing appreciation of the exchange rate for its currency, and what action Congress and the administration may need to take to address China's exchange rate policy and its effect on the U.S. and global economic recoveries and on U.S. job creation.

On Thursday, September 16th at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing to discuss the Treasury Department's report on international economic and exchange rate policies, with Treasury Secretary Timothy Geithner.

On Thursday, September 16th at 10am, in 2128 Rayburn, the House Financial Services Committee will hold a hearing on the SEC's exemption from compliance with the Freedom of Information Act under provisions of the Wall Street Reform and Consumer Protection Act.

On Wednesday, September 22nd at 10am, in 2128 Rayburn, the House Financial Services Committee will hold a hearing on the Fair Housing Act.

On Wednesday, September 22nd at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Services will hold a hearing on H.R. 4538, the Fair Access to Credit Scores Act.

On Thursday, September 23rd at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises will hold a hearing entitled "Assessing the Limitations of the Securities Investor Protection Act."

On a September date TBA, in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises will hold an oversight hearing on government-sponsored housing finance agencies, focusing on the efforts by the FHFA to recoup funds from the issuers of the underwater securities purchased by Fannie Mae and Freddie Mac and the present policies related to calculating guarantee fees.

On a September date TBA, in 2128 Rayburn, the House Financial Services Committee will continue to hold hearings on policy options for restructuring the nation's housing finance system.