ML STRATEGIES

Stamford
Los Angeles
San Diego
London
New York
Palo Alto
Boston

ML Strategies, LLC
701 Pennsylvania Avenue, N.W.
Washington, D.C. 20004 USA
202-434-7300
202-434-7400 fax
www.mlstrategies.com

Jason M. Rosenstock
Cheryl Isaac
Direct dial 202 434 7478
jrosenstock@mlstrategies.com

FINANCIAL SERVICES REGULATORY REFORM UPDATE

December 3rd, 2010

With the 111th Congress limping towards the finish line, it was interesting to see that two of the three biggest issues impacting the financial services industry this week emanated out of the administration and not Congress. Perhaps this is a precursor for how Washington will operate under the new gridlock everyone is anticipating for the next two years. Those three issues were: (1) the release of President Obama's National Commission on Fiscal Responsibility and Reform (the "Deficit Commission") report, (2) the release of a report by the Federal Reserve, mandated by Dodd-Frank, that disclosed who borrowed and how much money they took from the Fed during the financial crisis, and (3) negotiations surrounding the extension of the so-called "Bush tax cuts" and other tax incentives set to expire at the end of the year.

Despite the fact that the Administration seemed to be driving the news coverage, Congress did return to work on Monday for the start of its second lame duck session, the length of which remains unknown, though it is anticipated to ikely wrap up by the 17th of December when the recently enacted CR runs out. Any hope that anything beyond the tax cuts and funding the government could get passed took a serious hit when all the Republican Senators sent a letter to Majority Leader Reid indicating they will not consider any legislation until those two items are resolved. Clearly, the Republican Party eagerly looks towards 2011 and the 112th Congress.

DEFICIT COMMISSION RELEASES AND QUASHES REPORT

Right on schedule, on Wednesday the Deficit Commission released its 50-page set of recommendations for reducing the federal deficit, although it postponed voting on the report until Friday. With the Commission failing to garner the needed 14 out of 18 votes in approval of the report, the recommendations will not be sent on to Congress for an up or down vote. However, it is worth noting that a majority of the Commission would agree to the entire report was striking in and of itself. The Commission ranged from liberal Democrats to conservative Republicans, and yet the vote cut across party lines – with Sen. Dick Durbin (D-IL), Sen. Tom Coburn (R-OK) and Sen. Mike Crapo (R-ID) all voting in favor of the recommendations. Notably, five out of six of the House members voted no, while five out of six Senators voted yes. It came as no surprise that Sen. Kent Conrad (D-ND) and outgoing Sen. Judd Gregg (R-NH) supported the recommendations, as they were both responsible for the concept of a fiscal commission in the first place.

The report's recommendations were in part based on simplifying the tax code by reducing or eliminating many tax exclusions, and revising Social Security. Some notable recommendations made by the report included: taxing capital gains and dividends as ordinary income; eliminating some corporate tax breaks; expanding the saver's credit from the current limit of $1,000; capping tax-preferred contributions to retirement plans to the lesser of $20,000 or 20% of income; gradually increasing the Social Security early (64) and full (69) retirement ages, based on increases in life expectancy; increasing the amount of wages that are subject to the Social Security payroll tax; and reforming medical malpractice law.

On Thursday, the day before the Deficit Commission voted, Rep. Paul Ryan (R-WI) spoke about the Commission's Social Security proposals, noting that "common ground is evolving" between Republicans and Democrats in this area. Ryan is the incoming chairman of the House Budget Committee. He also stated his hope that Republicans and the Obama administration could determine areas for possible agreement, particularly on Social Security.

Despite not being sent to Congress as a whole package, one should expect to see some, if not most of the proposals find life in coming year. In fact, Administration officials have also stated that they will use some of the Commission's ideas in crafting President Obama's 2012 budget plan.

FED DISCLOSES DATA FROM FINANCIAL CRISIS LENDING

Also on Wednesday, the Federal Reserve released a slew of data available for transactions between December 1, 2007 and July 21, 2010, through its Term Auction Facility, Term Securities Lending Facility, and other programs including direct assistance to AIG and Bear Stearns. These transactions, nearly 21,000 in total, included both lending programs and mortgage-backed security purchases, and according to Fed officials, these rescue efforts worked as intended to support economic recovery. They added that the Fed took no credit losses on the many lending programs that closed earlier this year, and they expect no losses from the handful of facilities that remain open. As the public begins to digest this massive amount of data, outcry has begun over the numerous foreign entities to/from which the Fed made loans or bought up assets. More data will eventually be released on transactions occurring after July 21, 2010.

CHANGES IN THE MARKET FOR DEBIT AND CREDIT CARDS

Since the enactment of the Credit Card Accountability Responsibility and Disclosure (CARD) Act, which reduced companies' ability to use penalty pricing, regulators have begun noticing a change in credit card pricing and underwriting models. Credit card account solicitations have dropped, and the aggregate amount of outstanding credit card debt has also dropped. According the Federal Reserve Board Governor Elizabeth A. Duke, federal banking regulators will be paying close attention to the changes card issues are making in their business models, but it is difficult to tell whether these drops are due to new regulations, economic conditions or charge-off rates. She did state that about one-third of the decline can be attributed to the increase in charge-offs as rising unemployment and the weak housing market made it more difficult for cardholders' to pay their debts. She also believes that changing attitudes towards debt, widespread credit-line restrictions and rising interest rates are also responsible for the decline in credit card use.

Notably, while this usage has declined, debit card transactions were unchanged in both volume and value during the same time period. Duke predicted that after new standards are introduced for debit card interchange fees and routing transactions, there will be changes in checking account pricing and design, which may lead to more popularity of reloadable prepaid cards. She stated that the Fed will also be keeping an eye on mobile payments, which is not yet widespread in the United States, but has the potential to eventually be broadly adopted.

Dodd-Frank requires the Fed to create new standards to ensure reasonable fees, wider network access and other changes related to electronic debit transactions. The Fed has nine months after the July 10th enactment of Dodd-Frank to finalize these rules, and maybe believe a proposed rule with request for comment will come in early 2011, rather than in the next few weeks. Stakeholders are already acting to ensure that any new rules are in their favor, and comment letters are already being sent to the Fed, though none have been requested. Some of the "reasonable and proportional" interchange fee requirements set out in Dodd-Frank will not affect institutions with less than $10 billion in assets, nor will they apply to federal and state programs that use certain kinds of cards to distribute benefits. However, smaller institutions are concerned about other provisions in Dodd-Frank that might charge them the same fee as larger firms, which would be a greater percentage of the smaller firms' revenue.

SEC TO POSTPONE OPENING NEW OFFICES

As mandated by Dodd-Frank, the SEC was to open a Whistleblower Office, Office of Credit Ratings, Office of Municipal Securities, Office of the Investor Advocate, and Office of Minority and Women Inclusion. Now, because of "budget uncertainty," the agency will be deferring the creation and staffing of these new offices. The SEC expects to provide more information once a FY2011 budget is adopted. This postponement suggests that Republican tactics to stall the 12 annual appropriations bills and other funding will indeed stymie some Democratic reforms that have been enacted in the past couple years. Some are also using this as even further evidence that the SEC needs to be self-funded.

DEPARTMENT OF LABOR "TARGETS" THE TARGET DATE FUND

On Monday, Department of Labor's Employee Benefits Security Administration ("EBSA") announced a proposed rule that they believe is designed to help Americans better understand target date retirement funds and similar investment options found in 401(k)-type pension plans. The rule would provide specificity on the information that must be disclosed to participants and beneficiaries by amending the "qualified default investment alternative regulation" and the "participant-level disclosure regulation." The rule requires new disclosures about design and operation of target date investments including clarification of: an investment's asset allocation; how an allocation will change over time; and the significance of an investments target date.

According to Mintz Levin lawyer Alden Bianchi, "The proliferation of target date funds virtually assured that the regulators would take a second look. This new rule, which ups the bar regarding disclosures of information where target date funds are concerned, is entirely consistent with the Department of Labor's "participant" bias. While there is general consensus that some additional rules are needed on this score, the rule as currently written will impose significant new obligations on vendors. It is important to keep in mind that this is a proposed rule, which will hopefully be refined in response to comments."

BASEL III DETAILS FINALIZED

After meeting earlier this week, the Basel Committee on Banking Supervision announced that it finalized the last details of its new Basel III capital accord, which will include global regulatory standards on capital adequacy and liquidity. The full text will be released in mid-December, and the entirety of the Basel III rules will be published by the end of this year. In addition to capital and liquidity rules that were hashed out in July and September, the Committee agreed this week to a provisional methodology by which national banking supervisors will determine which banks under their authority should be declared systemically important financial institutions ("SIFIs"). This methodology will be passed to the Financial Stability Board for review, but in the meantime was not made public by the Basel Committee. This is the first step in creating new global rules on addressing the risk posed by "too big to fail" banks.

By mid-2011, the Basel Committee will be delineating how much additional minimum capital SIFIs should hold above what is set out by the Basel III capital rules. The Committee will also complete its review of going-concern loss absorbency that could be provided by different financial institutions, around the same time.

OFFICE OF FINANCIAL RESEARCH TAKES FIRST ACTIONS

The newly-established Office of Financial Research (OFR) at the Treasury Department made its first official statement of policy and request for comments this week. The OFR released its first notice, as a step in the process for adopting a universal standard for identifying parties to financial contracts. These legal entity identifiers ("LEIs") would be used in support of the Financial Stability Oversight Council's work to monitor systemic risk by determining connections among financial firms. According to the OFR, LEIs should be unique and nontransferable, persist over a firm's lifetime, and be capable of becoming the single international standard for unique identification of legal entities in the financial sector. The idea is for LEIs to aid in creating a reference datable of financial companies, according to the notice. The OFR is aiming to gather as much input as possible from the industry and international standard-setting organizations, and if a universal LEI is establish by July 15th, a rule would be issued mandating the use of that standard going forward.

HOUSE JUDICIARY COMMITTEE HOLDS HEARING ON FORECLOSURE PROTOCOLS

On Thursday, the House Judiciary Committee held a hearing entitled, "Foreclosed Justice: Causes and Effects of the Foreclosure Crisis," in order to examine irregularities in mortgage foreclosure procedures that led to the recent "robo-signing" incident. A panelist from the Office of the Comptroller of the Currency stated that her agency will be producing a report on its findings in early 2011. A New York bankruptcy judge also testified about the incompetent attorneys that he routinely encountered in court.

Chairman John Conyers (D-MI) stated that he was "relieved" to learn that the OCC will be encouraging financial institutions to stop "dual-tracking" – in which banks foreclose on a home while they are mid-negotiation with a homeowner to modify the mortgage. He noted that the Judiciary Committee's next hearing on this matter will be to question the principal financial institutions involved on why they rushed to foreclose on so many American families.

SENATE BANKING COMMITTEE HOLDS SECOND MORTGAGE SERVICING HEARING

A day after the House Judiciary Committee hearing, the Senate Banking Committee held its own foreclosure-related hearing, entitled "Problems in Mortgage Servicing From Modification to Foreclosure, Part II." Notably, FDIC Chairman Sheila Bair testified before the Committee, and called on the Financial Stability Oversight Committee (FSOC) to "take the lead" in mortgage servicing and foreclosure related issues. She stated that the FSOC is uniquely positioned because of its composition (besides Bair, it includes the heads of the CFTC, Fed, Treasury and SEC) to develop strategies in this area. Particularly, she would like the FSOC to address "the latest issues in foreclosure documentation deficiencies and proposing a sensible and broad-based approach to reforming mortgage servicer processes, promoting sustainable loan modifications and restoring legal certainty to the foreclosure process where it is appropriate and necessary." She noted that the potential for systemic risk is there, though it is not immediate.

WARREN SPEAKS OUT ON CFPB PRIORITIES

At a conference hosted by the Consumer Federation of America, special advisor to the President Elizabeth Warren asserted that the new Consumer Financial Protection Bureau (CFPB) should organize around its core principles, rather than creating narrow, "thou-shalt-not" rules that will be scrutinized for loopholes by lawyers. She explained that there will be a significant role for rules and enforcement actions at the CFPB, so long as those actions support the Bureau's mission. Warren stated that credit card and mortgage disclosures will be top priorities for the CFPB, with the goal of making prices clearer and product comparison easier. Apparently, she shares this goal with members of the financial services industry, including the President of the American Financial Services Association, who stated that "clarity, simplification, transparency [and] documents that are simple and easy to understand" are priorities "that the industry can broadly agree with."

The CFPB will not have any rulemaking authority or other key functions until a director is named by President Obama and confirmed by the Senate. Once this happens, these powers will be transferred to the new agency, along with an independent budget and broad authority to regulate financial products with little or no oversight by Congress. According to sources within the CFPB, they believe that they will be stood up and ready for the transfer by the July 21, 2011 time frame envisioned within Dodd-Frank.

SEC EXAMINING ENFORCEMENT OF PRIVATE EQUITY FUNDS

On November 23, only days after the proposed registration requirements for private equity, the SEC said it is already seeking to identify the priorities that should shape its enforcement program for the thus far lightly-disciplined industry. Private equity funds have received relatively little attention from the SEC because their advisers are largely exempt from registration under the 1940 Investment Advisers Act.

Money managers are bracing for change as a result of the Dodd-Frank Act. Dodd-Frank requires advisers with at least $150 million in private equity and hedge fund assets under management to register with the SEC. The SEC's asset management unit is working to develop priorities for private equity funds as well.

CFTC PROPOSES DERIVATIVES-RELATED RULES

On Wednesday, the Commodity Futures Trading Commission agreed by a 3-2 vote to issue a proposal that would define swap dealers and major swap participants through their actions and "distinguishing characteristics." Swap dealers would include any person that makes a market for swaps, regularly enters into swaps with counterparties "as an ordinary course of business" or holds itself out as a swap dealer or engages in activity "causing itself to be commonly known in the trade" as a market make for swaps. The proposal includes a de minimus exemption from this definition for parties that meet certain criteria. Major swap participants would be defined as parties that maintain a "substantial position" in any major swap category, with some exclusions.

The CFTC also proposed rules that would address the core principles and reporting requirements for designated contract markets (DCMs) and derivative clearing organizations (DCOs), plus reporting and recordkeeping requirements for swap dealers and major swap participants. The DCO proposed rules would change the current 90-day expedited application review to 180 days, and would require DCOs to adhere to both periodic and event-specific reporting requirements. These proposals all came in response to mandates from Dodd-Frank, and were unanimously approved, with the exception of the DCM proposal, which was approved 3-2. One of the two dissenters stated his concern that "these rules will present a deluge of potential outcomes that we have no fully explored and that may have negative impacts on the markets we regulate."

FINRA ENCOURAGES SRO MODEL, INDUSTRY RESPONDS

In a November 23 letter to the SEC, the Investment Advisor Association objected for a second time to the idea of creating a self-regulatory organization to examine—and potentially conduct rulemaking—for its industry. IAA wrote a second letter to reject statements in the Financial Industry Regulatory Authority's Nov. 2 letter. FINRA encouraged the SEC to delegate its authority over registered investment advisors to a self-regulatory organization (SRO) and accused IAA of trying to perpetuate a status quo of minimal oversight. IAA responded by saying many are opposed to the SRO idea and proposing increased congressional funding for the SEC so it can carry out its oversight responsibilities.

The SEC is currently looking into an SRO for registered investment advisors (RIAs) under Section 914 of the Dodd-Frank Act. This Section calls for the SEC to review the need for enhanced examinations of advisors and to recommend whether Congress should authorize the agency to create SRO(s). Section 914 was included in the legislation due to SEC Chairman Schapiro's testimony stating that, due to inadequate resources, the SEC only intermittently inspects the more than 11,000 firms currently registered as advisers. If the SEC recommends the change, RIAs would be regulated in a manner similar to the system in place for broker-dealers.

DEFINING PROPRIETARY TRADING A CHALLENGE FOR REGULATORS

One challenge to implementing Volcker rule restrictions on proprietary trading will be distinguishing those activities from legitimate market-making trades that financial firms regularly conduct in on behalf of clients. Senators Levin and Merkley have called the issue "challenging" but achievable. However, opponents of the rule regard the distinction as impossible to accomplish.

The Volcker rule is intended to prevent banking entities which receive federal guarantees from making speculative investments on their own behalf rather than the customers'. Section 619 of the Dodd-Frank Act prohibits the bank from acting as principal in the purchase or sale of any security, future or derivative. Because banks run market-making and proprietary trading activates from the same desks it is the job of financial regulators with the help of the FSOC to devise clear rules.

The FSOC is required to publish a study by January which will be a starting point for joint rulemaking involving the Fed, SEC, CFTC, FDIC and the OCC. In comments already submitted to the Council there can be seen a 'tug of war' between a narrow definition and a broad definition of market making. Key definitions, such as for market-making, trading account, short term and high risk asset, will determine the scope of the Volcker rule restrictions.

UPCOMING HEARINGS

On Tuesday, December 7th at 2:30pm, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing on the state of the credit union industry.

On Wednesday, December 8th at 2pm, in 538 Dirksen, the Senate Banking Subcommittee on Securities, Insurance and Investment and the Senate Homeland Security and Government Affairs Permanent Investigations Subcommittee will hold a joint hearing on "Examining the Efficiency, Stability, and Integrity of the U.S. Capital Markets."

On Wednesday, December 8th at a time TBD, in 2128 Rayburn, the House Financial Services Committee will hold a hearing entitled "A Proposal to Increase the Offering Limit under SEC Regulation A."

At a date TBD, in 419 Dirksen, the Senate Foreign Relations Committee will hold a hearing entitled "U.S. Global Competitiveness and National Economic Security."