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FINANCIAL SERVICES REGULATORY REFORM UPDATE

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After a two-week recess, Congress, the Senate and this update are back, having returned to a very different world then when they left. Although initially it seemed that the assassination of Osama Bin Laden may have been the type of game changing event that would have altered the political calculus on a whole host of issues, including the debt ceiling and deficit reduction, it instead appears that the triumphant mission only quieted the rhetoric briefly and will not have any substantive impact on congressional politics.

The House and Senate reconvened this week for an unusually long 14-week stretch during which at least one chamber will in session, as there will be no combined congressional recess for either of the early summer holidays. Perhaps this grueling schedule is why this past week was a relatively quiet one in Washington, with much of the action taking place on the sidelines, i.e., committee rooms, through the media, and in the case of the Gang of Six in back rooms out of sight from the public. However, the debt ceiling and the intertwining issue of deficit reduction continue to dominate the discussion in Washington. However, there are some Republicans who are arguing that there are alternatives to the binary choice of raising the debt limit vs. financial catastrophe that Geithner and economists have conveyed. In fact, even though Treasury Secretary Timothy Geithner and others have sent strong warnings to Congress about the grave consequences of defaulting on U.S. debt, a number of prominent Republican legislators are expressing their skepticism that this is anything more than a tactic to increase spending. Sen. Pat Toomey (R-PA), Sen. Jim DeMint (R-SC), Rep. Joe Walsh (R-IL) and others have retorted that Geithner's rhetoric is nothing more than "debt-limit hysteria" and fear-mongering. For these Republicans, the other option that needs to be on the table is for the U.S. debt bondholders to be paid with tax revenues that will stream into the Treasury regardless of the debt limit. As a result, under this plan other government programs (e.g., federal employees' paychecks, defense contracting work, highway maintenance etc.), which normally is funded by tax revenues, can instead be delayed or cut entirely without panicking markets or causing a major financial crisis.

Although this debate was anticipated to come to a head in the next few weeks, this past Monday Secretary Geithner notified Congress that the debt ceiling is not expected to be reached until August 2nd, one month later than initially estimated, due to stronger than anticipated tax revenues.

It will be interesting to see how this additional month alters the politics of the debate. The Gang of Six continues to meet and our understanding is that the latest proposal would require the Senate vote on a binding resolution instructing various committees to bring the Departments, agencies and programs under their jurisdiction to a set spending level. This would allow the committees to decide which programs to cut, to raise or to eliminate. If the committees are unable to satisfy this so-called "straight jacket" level of funding then the Senate as a whole would vote on across the board rescissions. Furthermore, it is also rumored that part of the Gang of Six recommendations will include instructions to the Senate Finance Committee to take up comprehensive corporate tax reform, with the possibility that this instruction will include a recommendation to move toward a territorial corporate tax system.

This past week also saw the commencement of another budget group, lead by Vice President Biden, which includes members of the House, Senate and Administration. While some believe that this group is ascending to replace the Gang of Six, which has been at work for a long time and has yet to formally announce any results, we believe that Biden's group is actually intended to produce a fallback, less controversial and more of a stop gap type of proposal in the event that the Gang of Six is not able to reach consensus on any recommendations.

In addition to the intertwined issues of debt ceiling and deficit reduction, this past week saw a fair amount of activity in the continued efforts to shape the regulations that will govern the financial services industry in the coming years, with the House and Senate engaging in major efforts related to Dodd-Frank implementation. However, the potential for even larger news will occur next week when the Senate Banking Committee holds another oversight hearing on Dodd-Frank implementation with all of the key regulators expected to testify.

BICAMERAL ATTACKS LAUNCHED AT THE CONSUMER FINANCIAL PROTECTION BUREAU

As the July 21st deadline to have the CFPB up and running and a Director confirmed quickly approaches, we saw a renewed flurry of attacks from both chambers against the CFPB. First, on May 4th, the House Financial Services Committee approved three bills that would limit portions of the CFPB's mandate. Subcommittee Chairman Shelley Moore Capito (R-WV) called the bills "good faith effort[s] to improve the structure of the Consumer Financial Protection Bureau" while Democrats on the Committee characterized the legislation as attempts to kill the agency. The proposals passed include:

1. H.R.1121, *the Responsible Consumer Financial Protection Regulations Act of 2011*, which would replace the Director of the CFPB with a five person commission.
2. H.R. 1667, *the Bureau of Consumer Financial Protection Transfer Clarification Act,* which postpones the date for the transfer of functions to the CFPB if the Bureau does not have a Director in place.
3. H.R. 1315, *the Consumer Financial Protection Safety and Soundness Improvement Act of 2011,* which would strengthen the FSOC's review authority over CFPB regulations.

In a statement, Elizabeth Warren condemned the bills as part of an attempt to prevent "the CFPB from operating effectively. Then on May 5, forty-four Senate Republicans, lead by Banking Committee Ranking Member Richard Shelby sent a letter to President Obama pledging to block the nomination of a CFPB Director if substantial changes are not made to the composition of the Bureau's structure and funding. The changes outlined in the letter include: making the CFPB subject to an annual appropriations process; replacing the Director with a board; and giving the FSOC greater authority to oversee Bureau rulemakings.

Both the legislative action and letter are seen as a line in the sand by Republicans and essentially a dare to the President to try to appoint a CFPB director by a recess appointment. However, there are numerous other critical vacancies in other regulatory bodies tasked with implementing Dodd-Frank and the concern is that a recess appoint of the CFPB director will effectively eliminate any chance of securing appointments for any of those positions. On the other hand, the appointment process has become so broken, it might behoove the Administration to make all of these appointments through a recess method and just move forward with the regulations. There will be two potential chances for the President, as there should be a recess break for both the Memorial Day and July 4th holidays.

HOUSE SUBCOMMITTEE PASSES BILLS AIMED AT MODIFYING PORTIONS OF THE DODD-FRANK ACT

The House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises favorably reported a package of seven bills that make changes to the Dodd-Frank reform legislation. The bills under consideration were:

1. H.R. 1070, *The Small Company Capital Formation Act of 2011*, which allows small companies to increase offerings from $5 million to $50 million without increased SEC securities regulation.
2. H.R. 1062, *The Burdensome Data Collection Relief Act*, which repeals the median compensation reporting requirements for publically traded companies
3. H.R. 940, *The United States Covered Bonds Act of 2011*, which creates a covered bond market in the United States.
4. H.R. 1082, *The Small Business Capital Access and Job Preservation Act*, which exempts private equity fund advisors from certain registration requirements.
5. H.R. 1539, *The Asset-Backed Market Stabilization Act of 2011,* which repeals Section 939G of the Dodd-Frank Act.
6. H.R. 1610, *The Business Risk Mitigation and Price Stabilization Act of 2011*, which exempts derivatives end-users from margin requirements.

The final bill under discussion was a measure introduced by Judy Biggert to allow churches to invest in collective trusts. The bill most fervently debated was H.R. 1062, the Burdensome Data Collection Act, which would repeal a provision of Dodd-Frank intended to highlight pay disparity between CEOs and employees. Democrats fought against the bill, saying that the provision is intended to shed light on potential systemic risks while Republicans argued the provision was over broad, duplicative and difficult to calculate. Another measure highly contested by Democrats on the Committee was H.R. 1082 which Representative Waters condemned as an effort to exempt private equity funds from reporting requirements and which would deny crucial protections to public pension providers.

These bills, almost all of which were introduced by freshman members of the committee, were more realistically designed for messaging and fundraising purposes, but it appears that the House GOP has decided to pass a significant number of small "fixes" to Dodd-Frank with the goal of then negotiating with the Senate to get a few signed into law. Senate Banking Committee Chairman Johnson has made it clear that he is not inclined to open up Dodd-Frank due to concerns that it could result in "mischief", however, we anticipate that later in the session some of these truly technical modifications will be approved – most likely though the Senate's unanimous consent process.

HOUSE COMMITTEE PASSES BILL TO DELAY DODD-FRANK CFTC RULEMAKING

On Wednesday, the House Agriculture Committee marked-up Rep. Frank Lucas' bill to "facilitate implementation of title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, promote regulatory coordination, and avoid market disruption" (H.R. 1573). Although not clear from its descriptive title, the bill would delay implementation of most of the new implementation rules that the CFTC was directed to write under Dodd-Frank. Lucas is the Chairman of the House Agricultural Committee, which has jurisdiction of the CFTC, and he has been vocal about giving regulators more time to implement "dozens of regulations that will touch every segment of the economy." He called this bill a "common-sense way" to give regulators 18 more months to write rules, and to acknowledge that Dodd-Frank set "impractically tight deadlines." This bill was initially introduced on April 15th, and has 18 co-sponsors. The committee vote was directly along party lines.

ANALYSIS INDICATES DODD-FRANK RULEMAKING DEADLINES WILL BE MISSED MORE FREQUENTLY

A recent analysis of Dodd-Frank rulemakings indicates that missed deadlines will be increasingly common. Over the next six months, regulators will be expected to complete one-third of the 386 rules required by Dodd-Frank with 27 final rules due in the second quarter of 2011 and 106 due in the third quarter. The SEC and CFTC, with the earliest deadlines, will be feeling the pressure more than other banking regulators—evidenced by a recent announcement by the CFTC that it will be missing deadlines on over-the-counter derivatives rules. Other agencies—such as the Fed, OCC and FDIC—get more time to finalize more complex rulemakings such as risk retention standards. Another reason for missed deadlines will be joint rulemakings which take substantially longer than standard rulemakings and are a key feature of the Dodd-Frank Act.

In response to missed deadlines, Ranking Member of the House Financial Services Committee and architect of the reform legislation, Barney Frank has said that regulators do not have a "gun at their heads." He stressed that, thus far, the pace of rulemaking has been satisfactory and that some delays may be necessary in order to produce the best possible rules—such as in the case of the delay of debit interchange fee rulemaking, although the conventional wisdom is that it is growing more unlikely that Congress will be able to successfully delay the interchange rules.

CONCERNS CONTINUE TO GROW WITH THE CFTC/SEC PROPOSED SWAP RULES

There continues to be a growing concern in the industry about the proposed regulation to govern the swap markets. Based on comments filed in late April, it is clear that representatives from trade associations and officials from the energy industry continue to be outspoken in their concerns over the regulation of swap transactions and the classification of energy firms as "swap dealers." Industry officials are concerned that the definition of a swap dealer laid out in the Dodd-Frank Act and a CFTC proposed rulemaking in December would apply to energy producers, distributors and other companies which provide electricity. These companies enter into swaps in order to hedge against fluctuations in commodity prices. As we saw with silver and other commodities this past week, prices can fluctuate rapidly, especially when new margin requirements are implemented.

There is also opposition to the proposed rule within the CFTC as well. Republican Commissioners Scott O'Malia and Jill Sommers voted against the proposed rule in December, voicing concerns that the definition of a swap dealer is too broad. In a speech on April 26, Sommers said the definition captures "many participants that in [her] opinion should not be considered dealers" and that the de minims exemption "is so narrow that it is unlikely to have much utility."

In response to these growing concerns, this past week the SEC and CFTC hosted a roundtable discussion to hear from industry representatives who shared their frustrations and anxieties over many aspects of the agencies' swaps rules. The Dodd-Frank Act directs the SEC to create a regulatory framework for security based swaps and the CFTC to oversee other types of swaps. The clear message (no pun intended) from industry to the commission was that regulators need to provide clarity on the breadth and scope of swaps rules.

Industry representatives pressed the agencies to agree on a hard timeline for implementation of new Dodd-Frank Act derivatives rules. Panelists expressed the need for a "hard date" or "roadmap" for full implementation of derivatives and swaps rules and how implementation will impact the industry. The panelists generally agreed that harmonization of the two agencies' rules is crucial to keeping compliance costs down. Likewise, panelists stressed that regulators must be flexible and give adequate time for the industry to adjust to new requirements.

At one roundtable discussion, participants concluded that the most efficient way to approach the swaps clearing requirements would be through a phased in approach. One participant said that, when phasing in clearing requirements, by "starting with the larger players that are more capable… you'll get more risk-reduction starting with swap dealers, then major swap participants, and moving to end-users."

CFTC's Director of the Division of Market Oversight, Richard Shilts, said when phasing in swaps rulemaking, the agency will look to swap types, asset classes, impacted markets and interdependence of rules in order to determine effective dates. Robert Cook, Director of SEC's Division of Trading and Markets, said that the SEC does not have a fixed timeline in mind but that it is the regulators' job is to implement rules "in a logical and cost effective manner." Cook also spoke to other concerns, including: discrepancies between SEC and CFTC rules; market impact of rules; whether different products and industry members warrant different regulatory approaches; and allocation of resources for those impacted by swaps rules.

CFTC Chairman Gary Gensler has repeatedly stressed that the December proposed rulemaking was "just a proposal and it is going to be very helpful to get the public's comments." We anticipate Chairman Gensler will be receiving a lot of questions about the pace and scope of his agency's rulemaking at the Senate Banking Committee on May 12th.

KEY HOUSE FINANCIAL SERVICES LEADERS FOLLOW UP GRILLING OF FSOC TO MAKE BIPARTISAN CALL FOR FED TO RESUBMIT SIFI RULE

On May 4, in a letter to the FSOC, the Chairman and Ranking member of the House Financial Services Subcommittee on Oversight and Investigation urged Council members to resubmit the proposed rule that lays out the criteria for designating non-bank systemically important financial institutions (SIFIs). The letter, asserts that the proposed rule is too vague and it did not provide opportunity for "meaningful" public comment. The Subcommittee leaders said the rule "simply restated the statutory considerations set forth in Dodd-Frank" and did not provide insight as to how the Fed would designate SIFIs. The FSOC should not be surprised to receive this letter given the public flogging that they received from the Chairman and Ranking Member at a hearing on this issue in April. Also not surprising is the tone of the letter, which urges the FSOC to reconsider how a SIFI designation would impact institutions such as mutual funds, hedge funds and insurance companies.

BERNANKE SEEKS TO ASSUAGE INDUSTRY FEARS OF BURDENSOME DODD-FRANK REGULATIONS

In a May 5 speech, Chairman of the Fed Ben Bernanke stressed that Dodd-Frank rulemakings will not be "ineffective or burdensome." He asked that the financial industry exercise patience and be respectful of the government's responsibility to overhaul the financial sector. He said, while it is imperative that the FSOC and other US regulators work to aggressively implement the Dodd-Frank Act, "no one's interests are served by the imposition of ineffective or burdensome rules that lead to excessive increases in costs or unnecessary restrictions in the supply of credit." Bernanke also addressed concerns on behalf of community banks, announcing that a committee—staffed by Fed governors Elizabeth Duke and Sarah Bloom Raskin--- is being formed to evaluate regulatory issues as they apply to community banks and other small institutions.

The speech addressed the new responsibilities of the Fed under Dodd-Frank including supervision of thrift holding companies, nonbank firms and certain other systemically important clearing utilities. Bernanke also spoke to new responsibilities of developing more rigorous standards for SIFIs such as capital and liquidity requirements, living wills, stress tests and risk management requirements.

SENATE FINANCE COMMITTEE HOLDS HEARINGS ON BUDGET ENFORCEMENT AND TAX POLICY

The Senate Finance Committee focused on the budget deficit, debt and reforming the tax code. On Tuesday, the Committee heard testimony from a panel of tax experts on the equitable distribution of tax burdens. While Senators on both sides of the aisle agreed that an overhaul of the tax code was necessary, Republicans made clear that the tax code should not be used to promote income equality and that the tax burden for wealthy Americans should be decreased.

On Wednesday, taxes also played a controversial role in the Finance Committee hearing on budget enforcement mechanisms. With the debt ceiling looming, Chairman Baucus said that Congress should develop a "framework for major deficit reduction over time" through budget enforcement mechanisms that would trigger automatic spending cuts or tax increases if deficit targets are missed. Committee Republicans balked at the notion of automatic tax increases if Congress fails to meet deficit targets while panelists stressed the need for an enforcement mechanism that was equally disagreeable to both parties.

US BANKS CONCERNED OVER FED MARGIN REGULATIONS AND IMPACT ON FOERIGN COMPETITION

Last month, the Federal Reserve proposed rules that would impose collateral requirements on the non-US divisions of US banks "without regard to whether the counterpart is located inside or outside the

United States." The rule would require banks to post 'margin' on any US swap trade not undertaken through a clearinghouse and this is the first indication that the Fed will try to enforce Dodd-Frank regulations abroad, which would certainly be one unique method to ensure proper harmonization. As expected, the response from the banking industry was harsh, with one bank executive saying that, although derivatives rulemakings have thus far not addressed international issues, this rule would create an unlevel playing field outside the US. A second bank official went even further, to state that that this proposal would be "economically destructive" for US banks unless European officials draft a similar rule with a similar timeline.

SEC COMMISSIONER SAYS AGENCY WILL REVISIT MUTUAL FUND RULE 12B-1

On April 29, SEC Commissioner Elisse Walter said that the agency will revisit a July 2010 proposal to reform Rule 12b-1 which regulates mutual fund distribution fees. The pending proposal would protect investors by limiting fund sales charges, increasing transparency of fees, promoting retail price consumption and revising oversight duties of fund directors.

In the year since the proposal was issued, the SEC has collected over 2,400 comments on the proposal, many of which oppose the changes to the rule. Walter said some of the issues the SEC must address are the "use of 12b-1 fees to pay costs associated with the administration of 401(k) plans," the preservation of investor choice, the need for "clear and comprehensible disclosure methods and how to achieve the goal of encouraging competitive pricing.

Interestingly, during the speech Walter brought the discussion of Rule 12b-1 back to Dodd-Frank implementation, saying that even before the agencies new Dodd-Frank responsibilities, the SEC was under staffed. She also stressed the need for increased SEC funding in order to "keep up technologically with the changes that have come in the marketplace."

FITCH FIRST RATINGS AGENCY TO COLLABORATE WITH MSRB ON MUNI BOND RATINGS

On May 4, Fitch Ratings and the Municipal Securities Rulemaking Board (MSRB) finalized an agreement wherein Fitch will provide free, real-time municipal bond ratings on the board's Electronic Municipal Market Access system starting in September. Chief Communication Officer at MSRB Jennifer Galloway said that "providing that information in a consolidated format to investors will be very helpful, and provide even more transparency and accessibility" to the municipal securities market.

UPCOMING HEARINGS

On Tuesday, May 10th at 10am, in 215 Dirksen, the Senate Finance Committee will hold a hearing titled "Perspectives on Deficit Reduction: Social Security."

On Tuesday, May 10th at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing on the final report of the Financial Crisis Inquiry Commission.

On Tuesday, May 10th at 1pm in 2154 Rayburn, the House Oversight and Government Reform Committee will hold a hearing on the Future of Capital Formation.

On Wednesday, May 11th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Domestic Monetary Policy and Technology will hold a hearing on the Federal Reserve's compliance with the Dodd-Frank Act and the Freedom of Information Act.

On Wednesday, May 11th at 2pm, in 2154 Rayburn, the House Oversight and Government Reform Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs will hold a hearing titled "Transparency as an Alternative to Risk Retention."

On Wednesday, May 11th at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises will hold a hearing related to capital markets and government-sponsored enterprises.

On Thursday, May 12 at 10am, in 538 Dirksen, the Senate Banking Committee will hold a hearing entitled "Oversight of Dodd-Frank Implementation: Monitoring Systemic Risk and Promoting Financial Stability."

On Thursday, May 12th at 10am, in 2128 Rayburn, the House Financial Services Committee will meet to mark up bills to extend the deadline for implementation of the Dodd-Frank Act's provisions regarding derivatives; to reauthorize the National Flood Insurance Program; and to improve the Consumer Financial Protection Bureau.

On Friday, May 13th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Oversight and Investigations will hold a hearing on the Stanford Financial Ponzi scheme.

On a date TBD, in 2128 Rayburn, the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity will hold a hearing on legislative proposals for the Federal Housing Administration and Ginnie Mae.

On a date TBD, in 2128 Rayburn, the House Financial Services Committee will hold a hearing to receive the Treasury's annual report on the state of the international finance system (originally scheduled for May 5th).

On a date TBD, in 2128 Rayburn, the House Financial Services Subcommittee on International Monetary Policy and Trade will hold a hearing titled "Legislative Proposal on Securing American Jobs Through Exports: Export-Import Bank Reauthorization."