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FINANCIAL SERVICES REGULATORY REFORM UPDATE

For the Week of May 3, 2010

The Senate continued with its second full week of consideration of the Regulatory Reform Bill, formally known as S. 3217, the Restoring American Financial Stability Act of 2010, by debating and voting on a handful of amendments. This coming week looms large as Democrats, led by Senate Leader Harry Reid have indicated that they intend to conclude the debate, while Republicans will fight to keep the debate going, at least for another week. With no votes scheduled for Monday and Friday of the week, it seems unlikely that the Senate will be able to deal with the nearly hundred or so amendments that have been filed. Because many of these have been authored by Democrats, and they make the bill even more liberal, chances are good that Leader Reid will relent and allow the debate to continue into the last week of May. This would also defuse any allegations that Democrats didn't allow Republicans the chance to use regular order during the debate, a complaint that resonated with the public during consideration of Health Care.

House Leadership is still publicly calling for a conference, though privately they are request input from members now in the event that a conference doesn't materialize. It would seem, given the significant public support for attacking Wall Street, that Democrats would want a televised conference, as Chairman Frank has indicated his preference for this as way to continue to hold the Republican's feet to the fire as protectors of Wall Street's interests. That said, conference or not, all indications appear to point to the President signing regulatory reform by July 4th.

AMENDMENTS GALORE:

During the past week the Senate debated and voted on a series of amendments, some of which passed in a bipartisan fashion. First among these was an amendment introduced by Senators Dodd and Shelby to dismantle the controversial $50 billion resolution authority trust fund and to replace it with an expansion of the federal government's powers to disassemble failing financial companies. Under the amendment, creditors of a failing firm could be required to pay back any funds beyond what they would have received in liquidation, FDIC debt guarantees would require congressional approval, and the Fed would only be allowed to provide emergency lending to solvent companies. This last provision would have precluded the government from aiding in Bear Stearns' sale to JPMorgan Chase in 2008. Dodd expects these provisions to keep failing firms from "holding our country hostage." Now, when the FDIC is forced to liquidate a failing financial company, the expenses will be covered by the financial services industry and creditors of the insolvent company, as needed. The amendment passed by a vote of 93-5.

The second bipartisan amendment, introduced by Senator Boxer, would explicitly prevent taxpayer money from being used to sustain failing companies, and instead pay for liquidations though the sale of assets and assessments on financial institutions. Her measures passed by a vote of 96-1. Additionally, an amendment by Senators Tester and Hutchison, forcing large banks to pay higher premiums for federal deposit insurance, was adopted by a vote of 98-0. The reg reform bill would have granted the FDIC permission to make this change, but the Tester/Hutchison amendment would require it to do so. Up to now, the FDIC's Deposit Insurance Fund, has been used to insure bank deposits up to $250,000, and has been funded by assessments based on banks' domestic deposits. The Independent Community Bankers of America posited that the amendment would reduce assessments on 98 percent of banks with less than $10 billion in assets, thus keeping almost $4.5 billion in community banks and communities over the next three years.

Senator Snowe offered two amendments that also passed, both of which were intended to lessen the regulatory burden on small banks, improve access to credit for small business owners, and protect consumer rights. Two other noteworthy amendments that passed were a whistleblower protection measure for employees of credit rating agencies, and a prohibition on manipulation of derivatives swamps markets.

An amendment offered by Senator Shelby to modify the proposed Consumer Financial Protection Bureau's, including limiting its powers over loan underwriting and state consumer protection laws, removing its enforcement powers, and moving the bureau from the Fed to the FDIC was rejected by a vote of 38-61. Two Republican Senators, Charles Grassley (IA) and Olympia Snowe joined with Democrats in defeating the measure. With this amendment's failure, the controversial CFPB continues to be created within the Federal Reserve, and would have the authority to write and enforce regulations for banks and credit unions with assets over $10 billion. The bureau would have to consult with regulators before proposing new rules, but would also centralize the authority that has been allocated over the years to seven different agencies. Shelby argued that the new consumer protection agency would be a massive bureaucracy and would unnecessarily expand the government's reach into the private sector.

OTHER PROPOSED AMENDMENTS OF NOTE

Senators Kaufman and Brown offered an amendment that could potentially break up or impose major restrictions on the biggest banks and financial companies. Their proposal would impose caps on the deposits that certain banks can hold, and a limit on other liabilities. Kaufman compared the concept to the break-up of AT&T and Standard Oil, and billed it as necessary in ending "too big to fail." Wall Street is understandably chagrined by the potential legislation, but it is backed by significant populist appeal.

A variety of amendments have been introduced in the securities realm, including Senator Specter's private right of action for aiding and abetting securities fraud. His proposed language would effectively overturn two Supreme Court decisions, and would revise the 1934 Securities Exchange Act to allow private lawsuits against "any person that knowingly provides substantial assistance" to another in violation of federal securities laws. Although his amendment was criticized by the U.S.

Chamber of Commerce, Specter managed to pick up quite a few co-sponsors. Senators Specter and Kaufman also introduced an amendment last week that would impose a fiduciary duty on broker-dealers, and would create criminal liability for brokers' willful violations of the duty.

Senator Nelson sponsored an amendment that would require the SEC to issue rules mandating nationally recognized statistical rating organizations to regularly monitor, review and update their credit ratings. Under the amendment, the SEC would also be authorized to fine, censure or otherwise sanction any of these rating agencies that fail to keep its ratings current and reliable. Senator Franken introduced an amendment that would require the SEC to establish a self-regulatory board to assign rating agencies the responsibility of providing initial credit ratings for structured finance products. Senator Menendez proposed an amendment that would require the SEC to obtain enhanced disclosures from issues, including a detailed written description of balance sheet activities and detailed justification for not including activities on a balance sheet. His amendment also included a requirement for issues to disclose transactions affecting future liquidity.

Senator Boxer introduced an amendment that would subject financial service providers to a fiduciary duty, which would be defined contextually. Her amendment would also give the SEC and CFTC authority to define, clarify and enforce the fiduciary duty with respect to regulated entities under their jurisdictions. Senator Feingold proposed an amendment that would give the SEC authority to restrict mandatory pre-dispute arbitrations where the SEC finds it necessary to do so in the public interest. Senator Hutchison proffered an amendment that would exempt small issuers worth less than $150 million from the Sarbanes-Oxley audit attestation requirements, and would require the SEC's Chief Economist to study how the commission can reduce the provision's compliance burden for larger issues.

Other proposals would impose the "Volcker Rule," barring banks from proprietary trading, and would reinstate the Glass-Steagall Act, which would maintain a firewall between commercial banking and investment banking.

An amendment introduced by Senator Sanders, for which a vote was expected on Thursday, has been pushed off, and more debate is expected on this controversial measure next week. Sanders' amendment would greatly expand the powers of the Government Accountability Office to audit the Federal Reserve. President Obama and Fed Chairman Ben Bernanke both expressed their hesitation because of the potential for independent monetary policymaking to be compromised. Late last week Sanders agreed to revise his amendment to remove the GAO audit of the entire Fed, and instead it would only require the Fed to disclose any businesses, individuals or foreign central banks involved in the emergency lending programs that ensued from the financial crisis.

Also, amendments dealing with the intra-party disagreements over Senator Lincoln's derivatives provision are anticipated. Senators Warner and Gillibrand have expressed their concern, and Obama advisor Paul Volcker and FDIC chair Sheila Bair have both explicitly warned of the extensive reach of Lincoln's derivatives amendment. It remains unclear whether the strategy will be to deal with this on the floor or in a conference. Also, still to be debated are Republican efforts to include the overhaul of Fannie Mae and Freddie Mac. Republicans argue that these cannot be excluded from a

regulatory reform bill because they have cost the taxpayers $126.9 billion, and also because in the eyes of many Republicans are the genesis of the crisis.

FCIC ADDRESSES SHADOW BANKING

Current and former Treasury Secretaries Timothy Geithner and Henry M. Paulson, Jr. testified before the Financial Crisis Inquiry Commission this past Thursday on the financial industry's "shadow banking" system. Both men advocated stricter regulation of financial markets, especially with regard to this network of investment banks, insurance companies, mortgage finance entities, and hedge funds that went largely without policing before the financial crisis.

Paulson specifically called for heightened awareness of securitization, commercial paper, repurchase agreements, derivatives contracts and money market mutual funds. He called the system of response to the financial crisis "archaic and outmoded," and stated his belief that "we had excessive complexity in financial products." Paulson endorsed the higher capital and liquidity requirements for financial institutions, which the Senate is currently debating in its reg reform bill. He stated his support for greater transparency in derivatives trading, and added his concern for 60 percent of financial assets being held in ten big institutions. He also acknowledged that regulation could never be perfect.

Secretary Geithner looked back on the financial crisis, characterizing it as an "avoidable failure," because "better-designed constraints in risk-taking" should have been in place. He tried to draw on the lessons from the Long Term Capital Management failure of 1998, but also noted that the executive branch only had limited emergency powers from which it could draw during the 2008 crisis.

SECOND THOUGHTS ON THE PROPOSED BANK TAX

The Obama administration's proposed 0.15% tax (estimated to raise $90 billion total) on liabilities of financial institutions with more than $50 billion in assets, has met some resistance in the House and Senate tax writing committees. Chairman Baucus of the Senate Finance Committee has stated his concern that the tax, if administered too broadly, could have a negative impact on community banks and small businesses. Senator Kerry echoed this concern, that the tax could potentially deter banks from lending money to small businesses. House Ways and Means Committee Chair Levin and Select Revenue Measures Subcommittee Chair Neal also agreed that more discussions are necessary.

Because of this hesitation, it is unlikely that the proposed tax would be implemented as quickly as the White House would like, and most likely will not be added to the Regulatory Reform bill, despite the stated desire of Senator Schumer. Secretary Geithner has promised to work with senators to "design this in a way that the threshold is sensible" for the tax's implementation, and Baucus pledged to better understand the tax's effects before enacting it into law.

The tax might also be put to a new use, if Senate Finance Committee Democrats have their way. The White House initially proposed the tax as a means of recovering money from the Troubled

Asset Relief Program, but Democrats are now pondering its use in paying for a bill that would revive dozens of expired tax provision and extend unemployment benefits. The bill, H.R. 4213, is currently being modified so that it can pass both chambers of Congress.

In his testimony before the Senate Finance Committee, Geithner noted that the new tax would only be levied on primary broker-deals, and only on certain assets - excluding firms' capital, insured deposits, and certain insurance policy reserves. The idea behind these limitations is to encourage financial institutions to hold less risky investment portfolios.

UPCOMING HEARINGS

On Tuesday, May 11th and 10am, in Dirksen 215, the Senate Finance Committee will hold a hearing to resume its discussion of the President's proposed fee on financial institutions regarding the Troubled Asset Relief Program, part 3.

On Tuesday, May 11th at 11am, in 2128 Rayburn, the Subcommittee on Oversight and Investigations of the House Committee on Financial Services will hold a hearing on "TARP Oversight: An Update on Warrant Repurchases and Benefits to Taxpayers."

On Tuesday, May 11th at 2:30pm, in 2128 Rayburn, the House Committee on Financial Services will hold a hearing entitled "Initiatives to Promote Small Business Lending, Jobs and Economic Growth."

On Wednesday, May 12th at 10am, in 2128 Rayburn, the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services will hold a hearing on "Use of Credit Information Beyond Lending: Issues and Reform Proposals."

On Wednesday, May 12th at 2pm, in 2128 Rayburn, the Subcommittee on Oversight and Investigations and the Subcommittee on Housing and Community Opportunity of the House Committee on Financial Services will hold a hearing entitled "Minorities and Women in Financial Regulatory Reform