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# FINANCIAL SERVICES REGULATORY REFORM UPDATE

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The biggest news of the past week was the near-shutdown of the federal government, which was avoided in the hours just before the most recent continuing resolution (CR) was set to expire. Negotiations continued throughout the day on Friday afternoon, and the stalemate that would have resulted in a complete stoppage of federal government operations was avoided shortly before the midnight deadline. According to published reports, the deal means that $37.8 billion dollars would be cut from President Obama's proposed 2011 budget through the remainder of the year. Shortly before midnight, the House and Senate passed a short-term CR to keep the government open for the week while the deal is put into legislative language and voted on sometime next week. It is clear that this agreement did not contain enough cuts for some of the more conservative members of the GOP, even though House Speaker John Boehner (R-OH), called the deal "as good a deal as we could get," as members of the Republican conference have already signaled their intention to vote against it.

The fact that some, and perhaps even a large percentage, of the more conservative members of the Republican conference will vote against the CR is not likely to derail passage, as we anticipate that enough moderate Democrats will vote for the resolution to ensure its passage. More worrisome are concerns that Boehner will not be able to get a majority of his conference to vote for a raise in the statutory limit in the debt ceiling. While the general consensus was that the markets would not have been adversely impacted by a short term shut down of the government, treating it akin to a blizzard shutting the government down, the failure to raise the debt ceiling is generally anticipated to be more like the reaction when Congress failed to pass the TARP legislation on its first go-round. This point was made this past week when Treasury Secretary Timothy Geithner warned again that catastrophic consequences could result if Congress does not raise the statutory debt ceiling. Testifying before a Senate Appropriations subcommittee, the Treasury Secretary said that a U.S. default on its debt "would make the crisis we went through look moderate in comparison," with a dramatic rise in unemployment, and the global financial system will be significantly harmed. He stated that the Treasury will hit the debt ceiling on May 16th, although some maneuvering could extend this to July. Regardless, of when the limit is going to be hit, it is clear that uncertainty associated with whether Congress will let the cap expire will create market turmoil.

With a deal reached on the 2011 CR, Congress can now turn its attention to the 2012 budget, with continued fights on spending and revenue priorities, and the debt ceiling vote. Both of which will not likely be dealt with any easier than the CR negotiations we just watched, and which will certainly make for an interesting, exciting and somewhat nerve-wracking spring in Washington.

## HOUSE BUDGET COMMITTEE PASSES FY2012 BUDGET PLAN

The House Budget Committee passed the House Republican FY2012 budget plan on a straight party-line vote of 22-16. The House is expected to take the $3.529 trillion framework soon, perhaps as early as next week. The plan calls for almost $6 trillion in spending cuts and over $4 trillion in cuts over the next decade, and makes some bold assumptions, including that Medicare and Medicaid are revamped, last year's health care reform law is repealed, and the Bush tax cuts from 2001 and 2003 are made permanent, among other things. The author and chair of the Budget Committee, Rep. Paul Ryan (R-WI), stated this confidence that the House will pass the budget plan, and given the rules of the House we fully agree with him.

During the markup many amendments were offered by Democrats in the Committee, but not were adopted with the exception of Rep. Chris Van Hollen's (D-MD) non-binding "sense of the House" proposal that responsible deficit reduction must also include looking at defense spending. Most of the proposed amendments would have increased funding for items such as transportation spending, financial regulation, and would have paid for these increases with ending or decreasing tax breaks and subsidies for ethanol, oil companies, outsourcing, corporate jets and wealthy individuals.

Though Ryan's plan may pass the House, it will have a much more difficult time getting through the Democrat-controlled Senate, where its release was met with serious skepticism by Kent Conrad, his Senate Committee counterpart. More likely to emerge from the Senate will be the deal created by the so-called "Gang of Six," a bi-partisan group of Senators working on their own budget framework.

## FRANK RESPONDS TO GOP'S PROPOSED BUDGET CUTS TO SEC AND CFTC

House Financial Services Committee Ranking Member Barney Frank (D-MA), one of the key architects of the Dodd-Frank Act, held a press conference earlier this week in response to the House GOP's recent FY2012 budget proposal. Frank has expressed concerned with short-term funding measures for the federal government, but he called Rep. Paul Ryan's (R-WI) budget proposal "significantly worse." Specifically, this proposal would fund the SEC and CFTC at FY2008 levels, equaling a decrease from current funding levels by 20% and 34%, respectively. Frank called this "an effort to re-deregulate the financial services industry... This is clearly not [about] money. This is based on [Republicans'] ideological opposition to regulation." Representatives from the Council of Institutional Investors and the Federal Bar Association's Securities Law Committee were also present, and spoke about the need for adequate funding of the SEC and CFTC, coupled with proper congressional oversight. They noted that taxpayers don't spend any money on these agencies, nor is the federal deficit affected by their funding – the SEC is fully financed by Wall Street fees.

## HOUSING FINANCE REFORM BILLS REPORTED OUT OF HOUSE SUBCOMMITTEE

A package of eight bills related to reforming U.S. housing finance was reported favorably out of the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises this past week, after the mark-up was delayed significantly by Democrats. As reported last week, House Republicans took a piecemeal approach to reforming Fannie Mae and Freddie Mac by introducing a slew of bills that would chip away at the GSEs' authority and existence. The bills were all passed by a voice vote, but one bill – requiring Fannie and Freddie to retain 5% of credit risk when securitizing loans – passed unanimously. Another bill, requiring the Treasury Department to approve any new debt issuances by Freddie and Fannie, had one abstention but was otherwise approved by 18 subcommittee members. The other bills were passed largely along party lines. Republicans view this reform package as a means of allaying taxpayers' fears that they will be responsible for GSE losses, while Democrats oppose the effort because they believe a much more comprehensive approach is necessary. The bills will now move on to the full House Financial Services Committee for a mark-up and vote, which has yet to be scheduled.

## KEY MEMBERS OF CONGRESS URGE REGULATORS TO ENSURE AN END USER EXEMPTION FROM MARGIN REQUIREMENTS

The chairmen of the Senate Banking Committee, House Financial Services Committee and Agriculture Committees of both chambers sent a letter to the heads of the CFTC, SEC, Fed and Treasury, urging the regulators to exempt end users of derivatives from margin requirements. Industry end-users, who use swaps to hedge risk in their activities, fear that the Dodd-Frank Act's clearing requirements would make their business overly expensive. The authors of the letter – Sen. Stabenow (D-MI), Sen. Johnson (D-SD), Rep. Frank Lucas (R-OK) and Rep. Spencer Bachus (R-AL) – argued that the agencies should "not create economic disincentives" and "seek to limit other regulatory burdens that could have the unintended effect of driving up costs for end users and increasing systemic risk for our economy." The legislators also urged the regulators to coordinate their rulemaking amongst themselves, in addition to those of international regulators. Dodd-Frank was clear in exempting end-users from clearing requirements for standard swaps, but the law was written less precisely regarding end-users and margin. CFTC Chair Gary Gensler has already stated that he would instruct his staff to write rules that would not impose margin requirements on end-users, citing congressional intent.

## REP. HIMES JOINS CHORUS OF LEGISLATORS URGING REGULATORS TO SLOW DOWN

At the Depository Trust and Clearing Corporations Thought Leadership Forum at the end of last month, Rep. Jim Himes (D-CT) advised members of the financial services industry to allow time for regulators to get Dodd-Frank rulemaking right before seeking Congressional action. Himes said that Dodd-Frank rulemaking is a "legitimately tough issue" which regulators may not be able to get "right right out of the box." He stressed that Congress should stay away from the issue—which could become an overly partisan battlefield—and give regulators the opportunity to "create an adaptive feedback loop within the regulators to over time get it right." Himes also asserted that regulators should be relieved from the aggressive timetable laid out in the Dodd-Frank Act. The strict deadlines for rulemaking could result in imperfect rules, said Himes.

## BIPARTISAN SENATE TAX REFORM BILL INTRODUCED WOULD END TAX EXEMPTION FOR MUNI BONDS

In one effort to reduce the budget deficit, Senators Ron Wyden (D-OR) and Dan Coats (R-IN) introduced legislation on Tuesday titled the Bipartisan Tax Fairness and Simplification Act of 2011. This legislation is similar to previous efforts lead by senator Wyden, and Senator Coats has taken the role that recently retired Senator Judd Gregg (R-NH) had in giving the proposal a bipartisan flavor. Some of the major provisions would hold the top individual rate at 35%, set the single corporate rate at 24%, eliminate the alternative minimum tax, eliminate deductions on debt financing, maintain family tax credits, and create a on-time tax repatriation holiday.

Notably, the Wyden-Coats bill would also end the tax exemption on bonds sold by states and localities. Specifically, the proposal would make all state and local debt taxable after 2011, and investors would receive a tax credit of 25% of the interest earned on the municipal debt they own. Although this is only one aspect of the larger budget deficit problem, Wyden asserted that there are far more efficient tax incentives than the current system and "this is a sensible option for not only broadening the base but for making the tax code more equitable, because – unlike a tax exemption – a tax credit allows taxpayers at all income levels to realize the same tax benefits." Others, however, are more skeptical. Charles Samuels, a partner at Mintz Levin Cohn Ferris Glovsky & Popeo PC in Washington, D.C. countered that "unless the Congress is highly confident, based on experience, that alternatives are going to work, they really should be careful about messing around with a fundamental part of our financing and infrastructure system."

## AIA URGES CONGRESS TO RENEW BUILD AMERICA BONDS (BABS)

On April 4, the American Institute of Architects (AIA) appealed to Congress to renew the Build America Bonds (BABs) Program. AIA released a report on March 31st, which detailed the benefits BABs have brought in the past two years, stating: "At a time when the building design and construction industry continues to face significant challenges in obtaining financing, BABs represent a successful and efficient tool for underwriting projects that improve the built environment and create jobs."

BABs are a kind of taxable bond, created in the American Reinvestment and Recovery Act of 2009, with the goal of helping state and local governments without adequate capital to build infrastructure and public works projects. The program allows states and localities to offer investors higher interest rates, resulting in lower borrowing costs for the governments and issuers. The AIA report asserts that BABs are responsible for over $180 billion in municipal debt issuance in 2009 and 2010.

Federal budget concerns make the future of the BABs program uncertain. The Vice President of Government and Community Relations at AIA, Paul Mendelsohn, said that AIA respects "Congress' concern for the deficit and the tough choices they must make, but delaying maintenance projects does not save our country any money" and cancelling the program will only exacerbate America's infrastructure problems.

## SEC AND FINRA PROPOSE NEW "LIMIT UP-LIMIT DOWN" RULE TO ADDRESS MARKET VOLATILITY

Working with the Financial Industry Regulatory Authority and national securities exchanges, the SEC filed a proposal earlier this week that would "establish a new 'limit up-limit down' mechanism to address extraordinary market volatility in U.S. equity markets." The new mechanism is intended to replace the SEC's circuit breaker approach that was temporarily put into place after the May 6th flash crash, and would instead require trades in listed securities to be executed within a specified price band tied to recent prices for the stock. The band "would be set at a percentage level above and below the average price of the security over the immediately preceding five-minute period. For stocks currently subject to the circuit breaker pilot, the percentage would be 5 percent, and for those not subject to the pilot, the percentage would be 10 percent." The proposal is subject to a 21-day comment period.

## SEC TO PROPOSE FIDUCIARY STANDARD FOR ADVISERS AND BROKER-DEALERS

On April 5, SEC Chairman Mary Schapiro told financial services industry leaders that the agency would be proposing a rule to create a single fiduciary standard for investment advisors and broker-dealers later in 2011. The announcement follows an SEC study released in January 2011 which recommended a uniform standard for those who give investment advice to retail customers.

Securities Industry and Financial Markets Association Chairman John Taft said a unified standard must be developed with care and acknowledge different business models used by advisers and brokers. Taft also warned that regulators must "balance on the one hand fully implementing the law … with on the other hand [ensuring] clients continue to receive the products and services they receive today." The Department of Labor is already engaged in a similar rulemaking and there is concern that the two agencies will not harmonize their rules.

## CFTC COMMISSIONER SPEAKS OUT AGAINST WHISTLEBLOWING PROPOSAL

At a Taxpayers Against Fraud forum in New York this past week, Commodity Futures Trading Commissioner Bart Chilton stated that his agency "really missed the mark" in its proposed rule on whistleblowing, which was required under Dodd-Frank. The proposal would allow whistleblowers to be eligible for up to 30% of monetary sanctions when they total $1 million or more, if the informants tip off the CFTC such that it leads to a successful enforcement action. The CFTC voted unanimously in favor of proposing the rule in November 2010, but Chilton stated that it would have to be altered "in some fundamental ways" before he would vote to finalize it. Chilton had four major concerns, related to nondiscretionary awards, discretion to comply with a company's internal procedures, blanket exemptions and liberal agency discretion "that could circumvent congressional intent." He argued for less discretion on the part of the CFTC, and mandatory awards for whistleblowers when there is a recovery, among other things.

## CFTC'S "BUSINESS CONDUCT" RULE FOR SWAPS CRITICIZED FOR OVERREACHING

At a meeting on pension plan investment regulations earlier this week, practitioners cautioned that recently-proposed CFTC rules on business conduct standards for swaps transactions would probably stop or severely hinder the ability of employee benefit plans to engage in swaps trading. The rule was proposed by the CFTC in December of last year, as mandated by Dodd-Frank, and would establish business conduct standards for swap dealers and major participants in how they interact with counterparties (including special requirements for employee benefit plans). The proposed rule would also define "adviser" and "best interest" in a way that would overlap with the Department of Labor's fiduciary standard.

Speaking on a panel at the meeting, an associate general counsel and managing director at a large financial institution expressed concern that a dealer might violate ERISA-prohibited transaction and fiduciary duty standards in order to enter into a swap agreement with a pension plan. One specific concern he raised was whether the term "swap" will carve out stable value funds. He noted that Dodd-

Frank requires the SEC and CFTC to conduct a study on these funds and determine whether they should be considered swaps by October 2011.

## FEDERAL REGULATORS TO TAKE ACTION AGAINST MORTGAGE SERVICERS

The Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS) and Federal Reserve Board will reportedly be releasing findings of their investigations into the practices of the top 14 mortgage servicing companies in the near future. Sparked by the robo-signing incident late last year, the federal regulators will also be issuing "cease and desist" orders that will direct most if not all of these companies to fix their problematic methods. The release of these findings appears to be related to a growing schism between the federal regulators and the coalition of state Attorneys General who were working together to reach a broad settlement agreement. Consumer advocates and many state attorneys generals have expressed disappointment in what they say is the lax federal response, which will not include monetary penalties or a reduction in borrowers' principal loan amounts. While there is also a chance that the attorneys general (working in tandem with the Department of Justice) could reach a broad agreement on servicing standards with the banks first, insiders count these odds as slim, because of the strong opposition by banks and the growing division amongst the AGs themselves on what the best settlement should be.

## NEW YORK FED RELEASES BEST PRACTICES FOR OTC DERIVATIVES MARKET

The New York Federal Reserve Bank released a letter from an industry organization on Tuesday, delineating best practices with regard to product standardization and enhanced transparency in the over-the-counter (OTC) derivatives market. The Operations Steering Group, comprised of dealers and buy-side institutions (26 financial holding companies, private equity funds and trade associations, in all), was created in 2005 by then-New York Fed President Timothy Geithner, as a way for industry to voluntarily improve market conditions, without the imposition of regulations. The Group sent its letter to the OTC Derivatives Supervisors Groups, comprised of the Fed, SEC, CFTC, and other U.S. and foreign financial regulators. The letter listed four main goals of the Operations Steering Group:

1. Increase OTC derivatives product standardization,
2. Expand central clearing,
3. Enhance bilateral risk management, and
4. Increase transparency.

The letter came on the heels of a major January meeting at the Fed of Group members and international financial regulators. In addition to listing its priorities, the Operations Steering Group letter also appraised ongoing efforts in the market to create comprehensive risk-mitigation standards, and laid out a set of new tasks in order to achieve their stated goals. The Group cited recent successes, such as the completion of a revised transparency and trade-reporting framework, and letdowns, such as the failure to finish a set of definitions regarding equities transactions.

## SENATE BANKING LEADERS CALL FOR QUICK NOMINATION OF NEW SIGTARP

On April 5, Senate Banking Chairman Tim Johnson (D-SD) and Ranking Member Richard Shelby (R-AL), in a letter to President Obama, called for the prompt nomination of a new special inspector general for the Troubled Asset Relief Program (SIGTARP). The former TARP Special Inspector

General, Neil Barofsky, resigned effective March 30th. Barofsky, appointed by President Bush in 2008, became progressively more critical of TARP throughout his service as SIGTARP. In late March he testified to the Banking Committee that TARP exacerbated the "too big to fail" problem.

The Banking Committee leaders noted in their letter that TARP still has $150 billion in federal funds pending repayment and continued oversight is essential to the return of funds. The letter also said, because the Congressional TARP Oversight Panel was disbanded on March 16th, "a strong, independent SIGTARP [is] more important than ever."

## TWO NAMES FLOATED FOR POSSIBLE CFPB DIRECTOR

Reports are indicating that the Obama administration is considering Federal Reserve Governor Sarah Raskin as potential head of the Consumer Financial Protection Bureau (CFPB). Raskin was just nominated by President Obama and confirmed by the Senate as a Fed Governor, and previously she was a congressional aide on the Senate Banking Committee. Another name that has been floated is former Michigan Governor Jennifer Granholm – the first female governor of her state. More recent reports indicate that she has declined consideration for the position.

## INDUSTRY ASSOCIATION WARNS OF ECONOMIC EFFECTS OF GLOBAL REG REFORM

On April 7, the Institute of International Finance, Inc. Managing Director Charles Dallara voiced concerns over Basel III and other global efforts at banking reform and urged governments to revise Basel III capital rules and liquidity standards. Dallara laid out his concerns about the impact of reforms on the global economy in a letter addressed to G20 finance ministers and central bank governors.

Dallara's primary concerns were liquidity standards, Basel III capital requirements and "too big to fail" institutions. Dallara said liquidity standards have "very significant market effects, given the narrow range of designated liquid assets, the bias to holding sovereign debt, and requiring all banks to move in the same direction on funding." He stressed that without reform these standards could weaken bank's ability to perform "basic retail and corporate services." Dallara's letter was also critical of capital requirement rules for systemically important global institutions. He warned that capital rules could further "exacerbate rather than reduce potential systemic risk by creating a new category of firms perceived to be too big to fail."

Basel Committee officials last month said they were close to a final agreement on additional capital standards of 2.5 percent in the form of common equity.

## UK FINANCIAL REGULATORS RELEASE PAPER ON COVERED BOND MARKET

Earlier this week, the UK Financial Services Authority and UK Treasury issued a joint consultation, confirming that UK banks' covered bonds would be protected, even if seller banks were to go under. As a reminder, covered bonds are securitizations backed by pools of mortgages, and are considered to be a very safe form of bank debt, because the issuer keeps the loans on its books, replaces the ones that are performing poorly, and there are special protections for bondholders should the issuer go bankrupt. EU banks are issuing a record number of covered bonds, and with the Congress considering whether to enact legislation that would allow US participants to more fully enter the covered bond market, this announcement came at an important time as analysts predict that it will improve the local market, which is already operating at unprecedented levels. In response to recent criticisms that some covered bonds are not offering investors sufficient information, the UK paper created a framework to make the products less opaque. The head of covered bonds at Deutsche Bank stated that "investors should take this paper positively as it should make the UK market even more transparent."

## UPCOMING HEARINGS

On Tuesday, April 12th at 10am, in 215 Dirksen, the Senate Finance Committee will hold a hearing title "Best Practices in Tax Administration: A Look Across the Globe."

On Tuesday, April 12th at 2:30pm, in 628 Dirksen, the Senate Homeland Security and Government Affairs Subcommittee on Oversight of Government Management, the Workforce and the District of Columbia will hold a hearing titled "Financial Literacy: Empowering Americans to Make Informed Financial Decisions."

On Tuesday, April 12th at 2:45pm, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing titled "Building the New Derivatives Regulatory Framework: Oversight of Title VII of the Dodd-Frank Act." Witnesses will include SEC Chair Mary Schapiro, CFTC Chair Gary Gensler, Treasury Assistant Secretary Mary J. Miller, Federal Reserve Board Member Daniel Tarullo, and industry representatives from the CME Group and LCH Clearnet Group Ltd.

On Wednesday, April 13th at 10am (subject to the change), in 2128 Rayburn, the House Financial Services International Monetary Policy and Trade Panel will hold a hearing on the Export-Import Bank.

On Wednesday, April 13th at 2pm (subject to change), 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 Thursday, April 14th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Oversight and Investigations will hold a hearing on the Financial Stability Oversight Council.

On Thursday April 14th at 2pm (subject to change), in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises will hold a hearing on risk retention.

On a date TBD, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit has announced it will hold a hearing on the Small Business Lending Fund, which was created by the Small Business Jobs Act of 2010 (PL 111-240). The $30 billion fund is intended to encourage lending to small businesses by providing capital to qualified community banks with assets of less than $10 billion.

On a date TBD, in 2154 Rayburn, the House Oversight and Government Reform Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs has announced it intends to hold a hearing titled "Small Business Lending Fund: TARP Dollars Redistributed to Incentivize Culture of Risk."