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ML Strategies Financial Services Update

For the week of February 14-18th

What felt like one of the longest weeks in Congress came to a close in the wee hours of Saturday morning when the House passed a stop-gap funding measure by a vote of 235-189 after several days of debate and consideration of hundreds of amendments. The continuing resolution ("CR") cuts $61 billion dollars from the current year's budget, including significant cuts at the SEC, though it is essentially dead-on-arrival in the Senate. The beginning of the week saw the release of the President's FY 12 budget, which trimmed $1.1 trillion dollars from the deficit in an effort to present the President as serious about reducing federal spending. However, the budget was generally panned as not being serious enough and Speaker Boehner made it clear it was DOA in the House.

The passage of the CR in the House also sets up two great fights for Congress when they return form the President's Day Recess (a/k/a District Work Period) on February 28th. First, the need for the Senate to pass and for both Houses to agree to a CR to keep the government operating past March 4th, and second the looming vote on increasing the debt ceiling. Despite reports that a government shutdown is imminent, we expect the Senate to pass another short term CR that the House will grudgingly accept, before both battles come to a convergence in April or early May. Absent both sides coming together to have the "adult conversation" that Speaker Boehner mentioned earlier this week, it should prove to be an interesting and exciting few months.

In addition to the budget battles, this past week saw the first Senate Banking Committee hearing under new chairman Tim Johnson (D-SD), which not-surprisingly, focused on Dodd-Frank oversight as well as the continuation of the robust oversight hearing schedule in the House Financial Services Committee with hearings on the implementation of the new derivatives rules and interchange fees among the topics covered. More on these hearings can be found below.

With Congress out of session next week, this update will be taking a brief hiatus barring any monumental developments.

OBAMA UNVEILS FY12 BUDGET
WHILE THE HOUSE DEBATES CUTS TO FY11 SPENDING LEVELS

On Monday the President released his FY 12 Budget proposal with its clear intention to slash $1.1 trillion dollars from the budget deficit over the next decade. Its release happened to coincide with the House Republican efforts to pass a CR for FY11 (which began in October of the last calendar year) resulting in some confusion to many analysts who appeared to have difficulty in avoiding conflating the President's budget with the proposed cuts in the House's legislation.

While the President's budget aims to provide a framework for modifying the corporate tax code, by lowering US corporate tax rates while simultaneously eliminating some of their tax breaks, it isn't clear whether industry will ultimately be supportive of the proposal. In addition, there is certain to significant pushback from some of the tax increases included in the proposal, including the resurrection of the "Financial Crisis Responsibility Fee" the fee whose last minute inclusion into the Dodd-Frank conference report nearly derailed the entire legislation. Similar to earlier proposals, this tax would be assessed on financial institutions with over $50 billion dollars in assets and will be used to fully compensate taxpayers for TARP. Given the incredible unpopularity of the fee last spring, plus the fact that most of the banks who accepted TARP funds have repaid those funds and that the entities that still haven't paid back their TARP funds (i.e., GM, Fannie and Freddie) would likely not be assessed the fee, we do not anticipate that this proposal will gain serious traction moving forward.

Another area of the President's Budget of interest to the financial services industry that will receive serious and significant debate is his proposed increase in funding for both the SEC and CFTC. Under the President's proposal, the SEC would receive a 12% increase over its FY11 budget (a percentage that would be even greater if the cuts included in the House passed CR are signed into law) to a budget of $1.407 billion dollars. The Administration is pressing for these increases based on the new responsibilities assigned to the SEC by the Dodd-Frank law, and further analysis of where the increased funds would go comport with this rhetoric. For example, within the Commission, it seems as if the Enforcement Division and specifically its Office of Market Intelligence would be a big winner with a 27% funding boost compared to 2010 levels. Another big winner would be the Division of Trading and Markets, which would get a 52% increase over FY10 levels to handle its new responsibilities, including central clearing for credit default swaps, short sales, broker-dealer registrations, and its existing responsibility of supervising trading in US exchanges, OTC securities and options markets.

The CFTC's requested increase is even greater, with the President asking for the Commission to receive an 82% increase from its current budget of $168 million to $305 million dollars. Additionally, the budget proposes creating user transaction fees as an option for Congress to offset some of the CFTC increases. Currently, the SECs funding is entirely offset by transaction fees, and in the event that the Administration's proposed increases are signed into law we would anticipate a significant increase in those fees for next year.

However, there is no guarantee that either the SEC or the CFTC will receive anywhere near the President's proposed funding level and this was clearly evident on Thursday when Democrats failed to restore $131 million dollars to the SEC for its FY11 budget from Republican spending cuts. The vote, which failed by a margin of 270-160 with only six republicans but 37 Democrats voting against party lines, will likely further strain one of the leading regulators tasked with implementing Dodd-Frank.

SENATE BANKING COMMITTEE HOLDS "PROGRESS REPORT" HEARING ON DODD-FRANK – CONCERNS ABOUT ADEQUATE FUNDING HIGHLIGHTED

On Thursday, the Senate Banking Committee held its first hearing under new Chairman Tim Johnson (S-SD), as the committee heard from all regulators tasked with implementing Dodd-Frank. The hearing highlighted the concern of some senators about the impact of limiting funding to the SEC among others, as well as previewed some of the committee members concerns about specific aspects of the legislation, including the pending interchange and risk retention rules.

Interestingly, when questioned about how potential budget decreases could impact her ability to implement Dodd-Frank, SEC Commissioner Schapiro stated that the lack of funding was not impairing the SEC's ability to engage in the rulemaking process but that "in order to operationalize any of the rules we are writing, we will require additional resources." Additionally, Schapiro note that the SEC was feeling pressure in keeping up with its core functions outside of new Dodd-Frank requirements, and specifically cited a technology deficit as a primary reason the SEC wasn't able to produce a timely report about the May 6th "Flash Crash". When pressed by Republican members of the committee, including Ranking member Richard Shelby (R-AL) and Bob Corker (R-TN) that the SEC should consider slowing down its pace of rulemakings, Schapiro reiterated that it was the core principles of the SEC that are most burdened by the current funding deficiencies, not the Dodd-Frank rulemaking. Nonetheless, we expect Republicans opposed to Dodd-Frank to try to utilize the SEC's request for additional funding as evidence to slow down the process.

Beyond questions surrounding SEC and CFTC funding, this hearing providing Senators on the Banking Committee the opportunity to tip their hands about which areas of the law they are most concerned about. Based on the line of questioning it seemed that the pending interchange and risk retention rules are at the forefront of the committee's rank and file membership, some of whom were undoubtedly pleased by the fact that Sheila Bair seemed to indicate that the proposed interchange rule may change greatly before it is finally implemented. Ms. Bair's comments added to clear signals from the Federal Reserve at a hearing on the contentions interchange issue earlier in the week that the Fed was open to further instruction from Congress how to deal with this problem.

HOUSE FINANCIAL SERVICES HEARS TESTIMONY ON INTERCHANGE FEE RULE DELAY

On February 17, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit heard testimony on the implementation of the Fed's interchange fee rulemaking which would cap debit transaction fees. At the hearing there was bipartisan support for legislation which would stop fast-track implementation of the rule. The Fed released the proposed rule on interchange fees on December 16, calling for a cap of 12 cents for most debit transactions.

The Fed appeared to be tipping its hand that it may open to reassessing its proposed interchange fee rules which could cost the industry billions. Fed Governor Raskin said the Fed is "reserving judgment" on the final rule until all the comments on it have been processed but clearly provided Congress with an opening to act when, in response to questions concerning the Fed's timeline, said that the timing of rule implementation is Congress' decision and the Fed will adhere to whatever timeline Congress decides on. As expected, many members indicated that they would be in favor of requiring the agency to take more time in crafting this rule. Concern also arose over the issue of fraud. Several representatives made clear that the timeline may hamper the Fed from fully vetting the fraud issue or that the rule itself would increase debit fraud. Another concern was how the rule would affect small banks and credit unions despite being exempted from the law. We expect legislation to be introduced in the House in the near future, and if passed, the legislation faces a difficult battle in the Senate.

HOUSE FINANICAL SERVICES COMMITTEE EXAMINES REGULATORY AND MARKET IMPLICATIONS OF THE NEW RULES FOR DERIVATIVES MARKET

On Tuesday, the House Financial Services Committee held a hearing to examine the impact of Title VII of the Dodd-Frank Act, the derivatives section. Witnesses included both government and industry, including someone from MillerCoors representing end-users.

In advance of the hearing the end users coalition received significant attention to a report put out by Keybridge Research that estimated that a 3% margin requirement on swaps end-users would lead to a cut in capital spending of between $5.1 billion and $6.7 billion, and a loss of between 100,000 to 130,000 jobs. However, as questions spread about the analysis behind the report, and then the subsequent self-removal of economic advisors such as Nobel laureate Joseph Stiglitz, from Keybridge's list of affiliate advisors, the report itself was widely discredited by time of the Committee's hearing. Of course, that did not stop many members of the committee from referencing the report during the hearing.

One of the largest issues surround the implementation of Title VII of Dodd-Frank deals with allowing "end-users" or companies that use swaps to hedge a business or commercial risk from being required to clear contracts through the clearing houses. Although Dodd-Frank specifically exempts such end-users, the business community is concerned that the CFTC and the Fed will require margin and capital requirements, either on end-users directly, or on swap dealers, which would likely require those counterparties to end-users to pass on those costs.

At this hearing, and later in the week before the Senate Banking Committee, Secretary Gensler reiterated that he thought the law was clear and that no such capital requirements should be imposed for non-financial end-users. This distinction, between financial and non-financial users was further refined by the testimony of Fed Board member Daniel Tarullo, who set forth a framework that appeared to indicate that some large end-users would have to post margin. Specifically, the Fed's approach would set thresholds for counter-party exposure under which margin would not be required. The risk threshold for nonfinancial end-users would be differentiated for financial versus non-financial companies and would be set "substantially higher than those for financial market participants" because, according to Tarullo, end-users in general pose a substantially smaller risk to the financial system and in many cases no risk at all.

The impact of the implementation of the derivatives section of Dodd-Frank to the future of the market was made clear the very next day with the announcement that D BÖRSE had purchased the NYSE Euronext exchange, in large part to capture the growing market for derivatives trading, with 37% of the new group's net revenues to come from that sector. Later in the week, we also saw discussions between the BATS and Chi-X exchanges move forward while the London Stock Exchange announced a deal with Canada's TMX.

ARE INSURANCE COMPANIES AND MONEY MARKET MUTUAL FUNDS HEADING TOWARD FSOC DESIGNATION AS SYSTEMICALLY IMPORTANT?

Although the Dodd-Frank Act clearly specified that bank holding companies with $50 billion or more in assets are systemically significant institutions, there is a growing concern amongst other large non-bank financial service companies that the FSOC may end up putting the dreaded "systematically important" bull's-eye on them as well. At this point, the concerns are entirely speculative since the FSOC has only taken the preliminary steps in its effort with several rulemakings. However, despite the fact that no

companies have been designated as systemic risks, some observers think that the FSOC will ultimately label some large life insurers and money market mutual funds as systematically important.
Included amongst these observers is Douglas J. Elliott, a Brookings Fellow who spoke at event earlier this week where he offered his perspective on the process. In particular, Elliott noted that life insurance companies use more leverage than property and casualty insurers, and are more interconnected with the financial system, and thus more likely to catch the FSOC's attention. Additionally, Elliott also said some money market mutual funds could be seen as potential risks, especially those that were rescued during peak crisis periods in 2008 and 2009, which makes them good candidates for special attention by the FSOC. Conversely, Elliott noted that other funds, such as traditional mutual funds and fund of funds groups may pose less risk because even though they may have great size in terms of assets, their collapse would be less likely to damage the broader financial system, noting that the same would be true for venture capital funds and private equity funds. Currently the FSOC is seeking comment on how to frame its risk analysis.

GEITHNER INDICATES THAT CORPORATE TAX REFORM CAN PROCEED SEPERATELY FROM CHANGES TO PERSONAL TAX CHANGES

On Wednesday, while testifying at a Senate Finance Committee hearing to discuss the President's budget, Treasury Secretary Geithner indicated that it was his belief that the budget would merely "tinker around the edges of the current tax system." While acknowledging that the President would like to go further than the current proposal, which essentially eliminates a series of tax breaks available only to U.S. Corporations, the Secretary also admitted that the debate was in the early stages. Interestingly, Geithner also indicated that he believed that Congress could make fundamental changes to the corporate code while avoiding consideration of the tax rates on individuals and families. Despite Secretary Geithner's comments, there is considerable debate about how this could work as millions of small-business owners pay their taxes through the individual, rather than corporate, code.

U.K. UNVEILS NEW, "TWIN PEAKS" STRUCTURE FOR REGULATION OF FINANCIAL PRODUCTS

On Thursday the United Kingdom's Treasury released its proposal that outlines how regulatory reform should be structured in the U.K., calling for the disbanding of the current tripartite system of financial services regulation in favor of a bifurcated, or "twin peaks" structure that separates the oversight of macro and micro-prudential issues from the conduct of business regulation. Under the proposal, many of the current responsibilities of the Financial Services Authority (FSA) will be handed off to a new agency to be called the Financial Conduct Authority ("FCA") and not the Consumer Protection and Markets Authority as originally proposed in December. Absent matters of nomenclature, the FSA will have considerable new powers, including the ability to ban products or limit their distribution for up to 12 months. Under current practice in London, the FSA had to wait to intervene until there was clear evidence of widespread consumer detriment. This shift was intended to put British regulators more in line with their US counterparts.

Additionally, the Bank of England will gain greater oversight of prudential regulation with the creation of an independent Financial Policy Committee (FPC) that will be responsible for "macro-prudential" regulation. Meanwhile, the Prudential Regulation Authority-a second independent entity within the Central Bank-will be in charge of regulating "micro-prudential" or firm-specific risks and a new specialist watchdog will oversee the conduct of businesses regulation.

BARCLAYS FORCED TO ADOPT COCOS BONUS PLAN – CREDIT SUISSE ISSUE DELUGED BY OFFERS FOR ITS COCOS

Bookending the week was two interesting developments in what could become the future of the bankers' compensation model. First, on Monday, British regulators failed to give approval for Barclay's bonus plan, which would have used contingent convertible capital notes a/k/a coco bonds or cocos, which are designed to convert to equity at a pre-agreed level of financial stress. As a result, despite the much anticipated development, Barclays was forced to use a simplified version which will simply be worthless if the bank's core capital ratio falls below some minimum level, rumored to be 7 percent..
Then on Friday, Credit Suisse was deluged by orders for its cocos, with the bank ultimately placing orders of $22 billion – eleven times its initial offer. Interestingly, asset managers took about two-thirds of the offer while private bankers took on a third on behalf of their clients. The success of Credit Suisse's offering leads some to believe in wider acceptance of the practice, although the fact that the Basel Committee on Banking Supervision has yet to speak on the matter may temper some of the excitement. The committee is expected to offer its views on cocos this summer and what is going to be a widely anticipated statement.

CFTC ANNOUNCES AGENDA FOR NEXT MEETING

On Thursday the CFTC announced its agenda for its next rulemaking hearing, its twelfth on Dodd-Frank implementation, which will take place on February 24th. On the docket for that hearing include rulemakings dealing with the following parts of the Dodd-Frank mandate:

- Registration of intermediaries;
- An anti-distributive trading practices authority interpretative order;
- Amendments to commodity pool operator and commodity trading adviser regulations;
- Swap date recordkeeping and reporting requirements for pre-enactment and transitions swaps; and
- Requirements for processing, clearing and the transfer of customer positions.

UPCOMING HEARINGS

The House and the Senate are in recess for the District Work Period next week and there are no major hearings planned.