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FINANCIAL SERVICES REGULATORY REFORM UPDATE

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This past week saw the beginning of the 112th Congress and the official transfer of power from Rep. Nancy Pelosi (D-CA) to Rep. John Boehner (R-OH). However, beyond the pomp and circumstance of new members being sworn in, there was little substantive work accomplished this week, with most of the real news in Washington devoted to the "palace intrigue" taking place at the White House. With President Obama announcing some personnel adjustments that seem transparently aimed at winning the hearts of the business community. To replace Chief of Staff Rahm Emanuel, who will be running for mayor of the city of Chicago, Obama chose William Daley, "a centrist with business ties." Daley's most recent post was as Midwest Chairman of JPMorgan Chase, but he also has significant experience running presidential campaigns and was President Clinton's commerce secretary. Further staffing changes are discussed below.

Committee assignments are still being determined, and we expect both parties to flesh out party ratios and leadership over the next couple weeks. Late on Friday, we learned that California Democrat Jackie Speier would leave the Committee, which should ensure that Gary Peters (D-MI) and Jim Himes (D-CT) will remain on the committee. Additionally, we anticipate that one other Democratic, likely Allyson Schwartz (D-PA) or Debbie Wasserman-Schultz (D-FL) will be added to the committee. Additionally, at least one other Republican will be named, although it is unclear who this is at the moment. However these ratios and placements ultimately play out the leadership of the committee is set with Rep. Spencer Bachus (R-AL) taking over as Chairman and Rep. Barney Frank (D-MA) will be Ranking Member. On the Senate side, there is less change because the Democrats remain in power, but committee ratios will be altered there as well. On the Senate Committee on Banking, Housing and Urban Affairs, the chairman from the 111th Congress retired, and the new head will be Sen. Tim Johnson (D-ND). The Ranking Member will continue to be Sen. Richard Shelby (R-AL). However, due to the decreased Democratic majority in the Senate there will be a need to adjust the ratios of the committee, which are currently at 13-10. It is not yet clear whether the final ratio will be set at 12-10 or 13-11, but we anticipate that the final ratio will be 12-10. If so, that would necessitate the inclusion of one additional Democratic member and three republican members to replace those on the committee who either lost or retired during the last election cycle. We hear that Senator Kay Hagan (D-NC) is the likely to fill the Democratic slot and that Ron Johnson (WI), Mike Lee (UT) and Rand Paul (KY) will fill the Republican slots.

GEITHNER URGES INCREASE IN DEBT LIMIT

One of the major issues facing the 112th Congress is whether or not it will increase the debt ceiling. On Thursday, Treasury Secretary Timothy Geithner sent a letter to Senate Majority Leader Harry Reid and other legislators, urging them to act on the debt ceiling, which he expects to be reached as early as March 31st. Geithner implored the Senate to raise the debt ceiling within the first quarter of 2011, and warned that otherwise the U.S. will default on its financial obligations – which he estimates could wreak a havoc worse than the financial crisis of 2008. According to Geithner, "Default would effectively impose a significant and long-lasting tax on all Americans and all American businesses and could lead to the loss of millions of American jobs. Even a very short-term or limited default would have catastrophic economic consequences that would last for decades." Geithner offered to take "extraordinary measures" as a last resort, including having the Treasury suspend the sale of its securities in order to delay the date when the limit is reached by several weeks.

In response, House Speaker John Boehner, just sworn in on Wednesday, stated that "the American people will not stand for such an increase unless it is accompanied by meaningful action by the president and Congress to cut spending and end the job-killing spending binge in Washington." He added that Democrats and the President will have to work with the GOP to cut spending and revamp the budget. Other Republicans, such as House Budget Committee Chairman Paul Ryan, recognized that the debt ceiling will in fact have to be raised. But he too called for deep spending cuts in the 112th Congress.

SENATE BUDGET COMMITTEE GRILLS CHAIRMAN BERNANKE

On Friday, the Senate Banking Committee met to examine the U.S. economic outlook, and had Federal Reserve Chairman Ben Bernanke as its witness. Bernanke spoke about the Fed's priorities, and the need for a stable job market and a "credible plan going forward." He believes that the economic recovery will be "moderately stronger" in 2011 than it was in 2010, but that unemployment rates will stay about the same. Bernanke was particularly concerned about public confidence in deficit reduction – he warned the Committee that "diminishing confidence on the part of investors that deficits will be brought under control would likely lead to sharply rising interest rates on government debt and, potentially, to broader financial turmoil." He advised Congress to demonstrate that deficit reduction is a priority.

Bernanke also spoke about inflation, which he projected to be at historically low levels for "some time." Both wage growth and consumer price inflation have slowed down over the course of the past few years (starting before the recession). Bernanke believes that unemployment will take four or five more years for the market to normalize in terms of unemployment as well. He cautioned that "persistently high unemployment, by dampening household income and confidence, could threaten the strength and sustainability of the recovery.

He commented on the Fed's controversial quantitative easing initiative, calling it a successful measure for stimulating long-term interest rates and a boost to the stock market. He clarified that quantitative easing is not government spending because it involved no purchase of goods or services, and added that the Fed earned $120 billion in interest from its securities remittances in the past two years.

Bernanke urged Congress to "take into account the low level of economic activity and the still-fragile nature of the economic recovery" in its financial policymaking, and to create growth and economic strength in tax and spending policies. He was strongly in favor of investments in research and development, in physical and human capital, in necessary public infrastructure, and to eventually reduce disincentives to work and save.

MINNICK CONSIDERED FOR TOP BANKING REGULATOR POST

Former Rep. Walter Minnick (D-ID) was reportedly in conversation with Treasury Secretary Tim Geithner earlier this week, in what are considered preliminary discussions as to whether Minnick might be a fit for certain regulatory positions that will be open in the near future. The Office of the Comptroller of the Currency is in need of a director (currently it is run by acting Comptroller John Walsh), and Sheila Bair's term as Chair of the FDIC is set to expire in June of this year. Rep. Barney Frank (D-MA) and Rep. Nancy Pelosi (D-CA) recommended Minnick for one of these jobs, and the administration is determining whether he might be a fit. Minnick lost his seat in the 1st congressional district of Idaho to Republican Raul Labrador.

REGULATORS CONSIDER TIERED APPROACH TO VOLCKER RULE

In determining how to implement one of the trickiest provisions of Dodd-Frank, the Financial Stability Oversight Council has circulated draft guidelines for the Volcker Rule that would use a multi-tiered test like that used to detect and fight money laundering. In this strategy, the first tier would involve "tripwires" that would alert banks' compliance departments, and would be based on trades that have certain measurable criteria. The second tier would have internal risk management departments question traders on the nature of their positions, and the third tier would involve regulators (with inspectors on the banks' premises) monitoring these tripwires, traders and compliance departments.

Industry experts welcomed the multi-tiered approach, and were also not surprised that the FSOC is considering it – many believe that a one-size-fits-all approach would be inappropriate in such a diverse market with a variety of products. One academic in the field opined that the multi-tiered approach combined with surprise visits to trading desks by regulators would be a sufficient approach.

Publication of final guidelines by the FSOC is expected in the next two weeks.

WHITE HOUSE STAFFING CHANGES

In addition to the announcement of Bill Daley to replace Rahm Emanuel as the President's Chief of Staff, it was announced that Paul Volcker, for whom the most controversial provision in the Dodd-Frank Act was named, will be resigning from his post as chairman of President Obama's Economic Recovery Advisory Board. The Board was created in February 2009, and was only intended to run for 2 years; it is still to be determined whether the President will renew the Board's mandate. Reportedly, Volcker has offered to continue informally advising the President on an as-needed basis.

As Lawrence Summers returns to Harvard University, President Obama just named his successor to director of the White House Economic Council. Gene Sperling previously served as counselor to Treasury Secretary Timothy Geithner, and was NEC Director under President Clinton. He was also a corporate philanthropy consultant for Goldman Sachs, a consultant and contributing writer for the West Wing, and an economic columnist and commentator for Bloomberg News. Sperling played a key role in shaping the legislation extending the Bush tax cuts in late 2010, and will now be a significant player in all of the Obama administration's economic policies going forward.

SEC FUNDING PROBLEMS PERSIST

Before recessing in December, Congress passed a continuing resolution that will maintain current budget levels in the federal budget through March 4, 2011. The move prevented the federal government from shutting down and allowed members of Congress to put off the budget debate until the 112th Congress was sworn in. In the meantime, the SEC's and CFTC's funding levels will continue to be the same as those of FY2010, though both agencies had requested considerably more in order to fulfill all their new Dodd-Frank requirements. As a result, SEC Chair Mary Schapiro recently announced a "temporary" delay in the creation of sever new offices, including the Whistleblower Officer, and that she expects there to be a significant impact on the agency's enforcement and market oversight efforts, both of which have already been cut back. Industry experts call this "disastrous" for Dodd-Frank implementation, and there is a renewed call for SEC self-funding as a result.

ISSA INTENDS TO USE OVERSIGHT PANNEL TO WEIGH INTO FINANCIAL SERVICES AREA

Rep. Darrell Issa (R-CA), the new chairman of the House Oversight Committee, has indicated a very long list of hearings planned for the 112th Congress, including his intention to examine, among other things the Financial Crisis Inquiry Commission and its failure to identify the origin of the financial crisis. According the Issa's office, the months-long investigation by the FCIC was intended to reach consensus, but instead will deliver results that are biased, controversial and highly partisan. Issa will be holding the hearing to determine whether there are some areas of agreement amongst the commissioners, and to understand why the 9/11 Commission was able to compromise, unlike the FCIC. Additionally, Issa has expressed an interest to examine how Elizabeth Warren is setting up the CFPB, and we anticipate that these hearings will be held in conjunction with efforts by Chairman Bachus and the House Financial Services Committee to significantly curtail the powers of the Bureau.

NEUGEBAUER TO CONSIDER BILL TO DELAY DODD-FRANK

Rep. Randy Neugebauer (R-TX), chair of the House Financial Services Subcommittee on Oversight, stated in an interview just before the New Year that he is considering introducing a bill that would mandate a one year delay on the implementation of Dodd-Frank. The yearlong hiatus would allow legislators to more fully understand the impacts and consequences of the regulatory reform law. In all likelihood, legislation of this nature would not go anywhere – once it passes the House, it would have a hard time passing the Democrat-controlled Senate and bypassing a presidential veto. Interestingly, one of the first bills filed by Michelle Bachman (R-MN), a tea party favorite was a complete repeal of the Dodd-Frank bill, legislation that has even less of chance of passage than Neugebauer's efforts.

CFPB SIGNS MOU TO COOPERATE WITH STATE REGULATORS

Just this week, the Consumer Financial Protection Bureau implementation team (housed at the Treasury Department and Conference of State Bank Supervisors (CSBS)) signed a memorandum of understanding to institute a foundation of cooperation and coordination between state and federal regulators on both regulation and enforcement. The goal is for all 50 states to sign the MOU, and after the announcement of the agreement, four did so immediately. A CSBS official did not think this would be a problem.

The MOU states that the CFPB and state regulators will support consistent examination procedures and effective enforcement of all laws, in addition to consulting with one another regularly. The CFPB and CSBS are expected to work closely with state attorneys general on law enforcement issues related to consumer financial protection, and more agreements with individual states and on specific issues are also possible.

INVESTMENT ADVISER OVERSIGHT TO SHIFT TO STATES

Under the Dodd-Frank Act, oversight of 4,100 investment advisers, with between $25 million to $100 million assets under management must be transferred from the SEC to state regulators in July of this year. Over a third of the firms will be handled by California, Florida, New York and Texas, in what is meant to be an increase in oversight. While the shift will relieve the SEC's burden – the SEC will only be examining about 9% of all 11,500 registered advisers in the next fiscal year – there is concern that states may have trouble handling the new responsibility as well. Both the SEC and states are having funding issues, which has led to discussion of investment advisers creating a self-regulatory organization that is funded by the advisers it oversees. Under Dodd-Frank, the SEC must submit a review of investment adviser examination by January 17th, at which point the agency may also suggest the creation of an SRO.

BROKER-DEALER STUDY TO BE DELIVERED THIS MONTH

In compliance with yet another Dodd-Frank mandate, the SEC will be delivering to Congress its report on investment advisers and broker-dealers. They study will be complete by its deadline of January 21st. On a related note, the SEC also adopted amendments to delay the sunset date for the temporary rule facilitating some proprietary trading by investment advisers who are registered as broker-dealers, for two years. The temporary rule grants investment advisers an alternative means to meet the requirements of Section 206(3) of the Advisers Act, when they act in a principal capacity with certain clients. The SEC purposely extended this rule so that its study on the two professions can first be released, thereby informing future regulation.

UPCOMING HEARINGS

Although the Senate will be considering a handful of remaining issues this weekend and perhaps into next week, no new hearings have been scheduled in either chamber in preparation for the holiday recess.