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FINANCIAL SERVICES LEGISLATIVE AND REGULATORY UPDATE

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Leading the Past Week

With both Houses of Congress officially back to start the second session of the 112th Congress, President Obama came up to the Hill and laid out an exhaustive agenda for the coming year leading up to the 2012 election. However, the conventional wisdom is that absent a few possible areas for agreement, much this agenda is D.O.A., at least until after the election, as the next ten months will be about positioning for what is widely anticipated to be the most incredibly active lame duck sessions since 1980 election. Also on the Hill last week was newly minted CFPB Director Richard Cordray who took a markedly different approach than that of Elizabeth Warren, as he responded to a barrage of questions from members of the House Oversight Subcommittee on a range of topics including his recess appointment, small business review panels and a recent CFPB/FTC MOU. Republican efforts to amend Dodd-Frank were also on display this past week as the House Agriculture Committee approved a series of six bills aimed at modifying the derivatives section of the law. Over in the Administration, in a dog bites man story, Treasury Secretary Geithner confirmed he will pursue other interests, not expecting to be asked to serve again when Obama is reelected. Finally, the Fed announced it will continue to target a zero interest rate through 2014 given continued high unemployment, and, for the first time, the central bank announced it will begin explicitly targeting inflation at 2 percent.

State of the Union

On January 24th, President Obama gave his third State of the Union address, or as Republicans viewed it, a major campaign re-election speech, where he laid out an aggressive agenda for the coming year. Among other new domestic programs, the President introduced a new Trade Enforcement Unit, corporate tax overhauls, homeowner refinancing assistance programs and a new push for increased taxes on the wealthy.

In regards to corporate tax reform, the President said in his address that he wants to simplify the tax code by broadening the base of taxable income and reducing tax rates. He also outlined new tax policies to increase manufacturing, incent companies to move operations back to the US and expand tax relief to small businesses. A more concrete tax reform proposal will be coming out of the White House over the coming months, possibly around the same time as the President's fiscal year 2013 Budget request.

As part of a stronger stance towards China, Obama also announced creation of a Trade Enforcement Unit with the goal of investigating unfair trade practices abroad. Citing China as an example of a country that does not "play by the rules," Obama said the new unit will ease the backlog of trade cases and investigations, creating jobs. The President also announced the formation of a new Financial Crimes Unit which would house "highly trained investigators to crack down on large-scale fraud and protect people's investments." The Financial Crimes Unit announcement continued the theme of consumer financial protection—in which Obama took the opportunity to laud Richard Cordray as a consumer "watchdog."

It was also announced that within the President's Financial Fraud Enforcement Task Force formed in 2009 to oversee investigations of financial crimes across agencies and focused on financial institution misconduct pooling and selling residential MBSs, would be a new Residential Mortgage-Backed Securities Working, led by New York Attorney General Eric Schneiderman. Schneiderman will be joined on the working group by Lanny Breuer, assistant attorney general of DOJ's criminal division, and Robert Khuzami, director of enforcement at the Securities and Exchange Commission who will lead federal efforts.

The working group will be separate from the ongoing investigations into robo-signing and other improper mortgage servicing practices led by Iowa Attorney General Tom Miller. Miller's investigation has already lasted over a year—casting doubts on whether a final settlement is still possible. Even if a settlement was close, it would seem likely that the announcement of Schneiderman's group will throw cold water on any potential deal as banks would be unlikely to willingly subject themselves to double exposure.

<u>Legislative Branch</u>

Senate

Senate Permanent Subcommittee on Investigations Holds Hearing on Tax Policies Impacting Mutual Funds:

On January 26th, in what became a rather testy exchange with the Chairman and Ranking member of the Senate Permanent Subcommittee on Investigations, IRS Commissioner Douglas Shulman pushed back against overtures from lawmakers, saying that he would not attack mutual funds for their use of offshore entities to avoid US tax rules governing commodities investments. However, in deference to the obvious pressure from the Chairman and the Ranking member, Shulman did say that the IRS will study the issue and seek guidance from other agencies and clarification from Congress in the form of clearer laws. Currently, the IRS uses letter rulings to spell out its position on the reading of tax laws; however, Chairman Carl Levin (D-MI) and Ranking Member Tom Coburn (R-OK) both expressed doubts about the IRS's letter ruling regarding mutual funds, asking Shulman to revoke to rulings and end the practice to ensure mutual funds are given equal treatment.

Chairman Levin, continuing his vendetta about the potential for these private letters to facilitate further speculation in commodity markets cited a CFTC study which found 80 percent of crude oil contracts are held by speculators. Nevertheless, Shulman pushed back, arguing that mutual funds are not guilty of the type of tax avoidance behavior which the IRS targets, such as creating fake losses or inflated basis. In regards to mutual fund commodity investments, "there is no tax being avoided," said Shulman, adding that, "there's tax paid on those investments in the U.S. by the mutual fund shareholders, just as if those mutual fund shareholders weren't in a mutual fund and were investing indirectly in commodities." Interestingly, the Committee failed to include a witness from the industry, choosing only to hear from the IRS and the US Treasury on the matter.

Senate Budget Examines Outlook for US and Global Economies:
On January 26th, the Senate Budget Committee met to hear expert testimony on, and discuss the outlook for, the US and global economies. Much of the discussion focused on how to continue to sustain a US economic recovery in light of potential risks of financial contagion from Europe and growing US debt. A major theme of the hearing was concern over the aging of the population and rising health care costs as it relates to entitlements and federal spending. There was general consensus among witnesses—which included former Federal Reserve Board Governor Alan Blinder— that Congress must address entitlements, focusing on reducing government outlays in this area, rather than discretionary spending.

Another theme that emerged during the hearing was how to address the still struggling housing market. Several Senators questioned witnesses on how to improve the handling of underwater and foreclosed homes and how to increase housing starts. Ideas floated on how to improve the housing situation included changing the terms of Fannie and Freddie conservatorship, broadening the availability of refinancing options, allowing Chapter 13 bankruptcy for underwater homeowners and reducing the principle. Additionally, lawmakers addressed the lack of budget from the Senate in recent years. Chairman Conrad (D-ND) promised the Committee they will hold hearings on a FY2013 budget shortly and hear from a number of officials on the budget outlook in upcoming hearings.

Reid Plans Test Vote for STOCK Act:
Senate Majority Leader Harry Reid (D-NV), following President Obama's reference in the State of the Union, has scheduled a test vote on the Stop Trading on Congressional Knowledge (STOCK) Act (S. 2038), set for January 30th. The legislation is a combination of Senators' Scott Brown's (R-MA) and Kristen Gillibrand's (D-NY) bill which was approved by the Senate Homeland Security and Government Affairs Committee in December. The January 30th vote will judge whether the measure to ban Congressional trading on confidential information will be able to find the necessary sixty votes to move forward.

House of Representatives
Cordray Testifies Before House Oversight Committee:
On January 24th, Richard Cordray testified before the House Oversight and Government Reform Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs in his first appearance before Congress since his controversial recess appointment to be Director of the CFPB. Cordray's appearance as head of the CFPB was very different from what we had come to expect from Elizabeth Warren who became known for her clashes with House Republicans. Many lawmakers focused on the contentious nature of Cordray's appointment and, notably, Representative Issa (R-CA) asked Mr. Cordray of any plans to build redundancies into CFPB rulemakings so as to ensure they withstand legal challenges and remain in place should his appointment later be determined to be unlawful.

Cordray highlighted a number of priorities for the coming months and year, including the beginning of the CFPB's nonbank supervision of payday lenders, mortgage originators and student loan providers. In addition to new nonbank activity, Cordray made it clear that the CFPB's top immediate priority is the mortgage disclosure form overhaul of the Real Estate Settlement Procedures Act (RESPA) and the

Truth in Lending Act (TILA). Cordray said the Bureau has been working on this issue for some time and anticipates a final rule to out in the late 2nd or early 3rd quarter of this year. For more on this see the CFPB section below.

Agriculture Committee Approves 6 Bills Targeting Dodd-Frank Reforms:
On January 25th, the House Agriculture Committee approved six bills aimed at limiting the scope of forthcoming regulation of derivatives markets mandated by the Dodd-Frank Act. All six bills were approved by voice vote with bipartisan support, though Ranking Member Peterson (D-MN)—despite not voicing any opposition to the legislation— suggested that it may be premature to pass the bills given their focus on future regulations.

Three of the bills were approved last November by the House Financial Services Committee, which shared jurisdiction over their content. Those bills—H.R. 2682, the Business Risk Mitigation and Price Stabilization Act of 2011; H.R. 2779, a bill to exempt inter-affiliate swaps from certain regulatory requirements; and H.R. 2586, the Swap Execution Facility Clarification Act—would exempt certain institutions from margin requirements, limit the reach of certain requirements, and prevent the CFTC from establishing a minimum number of participants requirement for swap execution facility bids, respectively.

The remaining three bills fell under the sole jurisdiction of the Agriculture Committee. Those bills, H.R. 1840, a bill to improve consideration by the CFTC of the costs and benefits of its regulations; H.R. 3336, the Small Business Credit Availability Act; and H.R. 3527, the Protecting Main Street End-Users from Excessive Regulation—would require the CFTC to conduct cost-benefit analysis of all regulations, exclude farm credit and other institutions from the definition of swap dealers, and prevent the CFTC from considering transactions designed to hedge or reduce commercial risk. Even though it is likely that all, or some of these bills may be passed by the full House of Representatives, there is little chance that the Senate will consider any of them in the near future.

House Financial Services Republicans Ask for Confirmation that US will not Bailout Europe:
On January 25th, leading Republican members of the House Financial Services Committee sent a letter to Treasury Secretary Timothy Geithner, Chairman Spencer Bachus, Vice Chairman Jeb Hensarling and the chairmen of the Committee's six subcommittees. The letter asked for affirmation that the Administration will not seek to use any taxpayer money to bailout Europe's debt crisis through contributions to the International Monetary Fund (IMF), which recently requested an additional $500 billion from member countries to respond to the European financial situation. Lawmakers who signed the letter included the committee's entire subcommittee chairman roster: Representatives Scott Garrett(R-NJ), Ron Paul (R-TX), Shelley Moore Capito (R-WV), Judy Biggert (R-IL), Gary Miller (R-CA) and Randy Neugebauer (R-TX).

Representative Miller to Retire in Face of Redistricting Challenges:
Last week, Representative Brad Miller (D-NC), a senior, influential and thoughtful member of the House Financial Services Committee, announced he will not run for another term. Miller's decision to retire was influenced by North Carolina's redistricting design which placed him in the same district as his friend and mentor Representative David Price (D-NC).

<u>Executive Branch</u>
CFPB

Cordray Promises to convene Small Business Review Panel on Mortgage Disclosure Rulemaking:
On January 24th, during a House Government and Oversight Subcommittee hearing, and in response to direct questioning by members of the Committee, Cordray promised lawmakers that the Bureau will hold a small business review panel to evaluate the potential impact on small business from the combining of the mortgage disclosure forms required by the Truth in Lending Act (TILA) and Real Estate Settlement and Procedures Act (RESPA). Citing the review panels as evidence of the Bureau's unique oversight requirements compared to other financial regulators, Cordray indicated a passing appreciation of the requirement saying: "It is one of the oversight mechanisms you all put in place for us. It is totally appropriate." The CFPB is one of only three agencies (the other two being the EPA and OSHA) that must comply with the requirements under 1996 Small Business Regulatory Enforcement Fairness Act (SBREFA) to convene such panels.

However, with the CFPB preparing to engage in an aggressive rulemaking agenda, it was interesting to note that Cordray failed to fully embrace a commitment to the issue, saying he would convene the panels as required by law. Cordray's promise to lawmakers may have been the result of a letter, where the Chamber of Commerce and 14 small business organizations criticized the Bureau for failing to meet its SBREFA mandate. In a letter, the groups said it "is unfortunate that the CFPB has worked for more than nine months on re-designing mortgage documents, narrowing down the choices for a new form, without convening" a Small Business Advocacy Review (SBAR) panel and questioned the Bureau's commitment to SBAR compliance in future rulemakings.

CFPB and FTC Enter into MOU Promising Coordinated Rulemaking:
On January 20th, the CFPB and FTC signed a memorandum of understanding outlining the agencies' commitment to cooperation and to "prevent duplication of efforts, provide consistency and ensure a vibrant marketplace for Consumer Financial Products or Services." The FTC approved the MOU with a vote of 4 to zero. The FTC "has always been committed to protecting consumers and legitimate companies from bad actors," said FTC Chairman Jon Leibowitz and "this agreement ensures that businesses will not be double-teamed by the two agencies." Richard Cordray, CFPB Director, echoed Leibowitz's sentiments saying the MOU is "important to making sure markets for consumer financial products are getting efficient and effective federal oversight."

The MOU states that the FTC and CFPB will coordinate on law enforcement actions, potential court activities and administrative proceedings so as to maximize resources, eliminate redundancy, lessen duplication and increase efficiency. Specifically, the MOU states both agencies, before beginning an investigation, will determine if the other agency has: investigated the person of interest; filed a court action or administrative proceeding against the person of interest; or obtained a judgment against the person of interest for violation of consumer laws. The MOU also provides for consultation on rulemakings designed to address unfair, deceptive or abusive acts.

Federal Reserve
Federal Reserve Keeps Low Rates and Sets Inflation Target:
On January 25th, the Fed announced during its Federal Open Market Committee (FOMC) meeting that it will maintain its zero interest rate policy through 2014—citing fears that continued difficulties in the housing market and troubles abroad could dampen the ongoing recovery. The federal funds rate has been targeted for zero to 0.25 percent since December 2008; this latest announcement extends the policy beyond its previously projected end date of mid-2013. The announcement comes as the Fed predicts high unemployment will persist and not fall to below seven percent until 2014. In addition, with

deference to its dual mandate of pursuing full employment and price stability, for the first time since the crisis, the Fed formally announced an inflation target of 2 percent. A policy priority of Chairman Bernanke, setting an official target brings the Fed in line with central banks around the world. In the past, the informal inflation target was believed to range from 1.7 to 2%.

Treasury

Geithner Will Not Serve as Treasury Secretary in 2nd Obama Term:

On January 25th, in an interview with Bloomberg Television, Treasury Secretary Tim Geithner said he is "confident" the President will not ask him to continue to serve as Secretary. Amid rumors that Geithner would resign after last summer's debt-limit debate, Geithner said the President has asked him to remain in his post through the November elections. There has not been much speculation on who will replace Geithner; however, Mark Calabria, director of financial regulation studies at the Cato Institute has predicted Erskine Bowles and Senator Kent Conrad could be among potential candidates. Other possible contenders could be Gene Sperling, Roger Altman, Jeffrey Immelt or perhaps a dark-horse candidate. Given his recent criticisms of Obama, it would appear that Jamie Dimon is no longer on the short list.

CFTC

Groups Challenging CFTC Position Limits Rule Suffer Procedural Setback:

On January 20th, a three judge Washington US Court of Appeals panel found that it does not have jurisdiction to consider challenges to the CFTC's position limits rule, saying the Dodd-Frank Act is "silent" on if rules may be directly challenged in appeals court. The challenge has been brought by the International Swaps and Derivatives Association (ISDA) and the Securities Industry and Financial Markets Association (SIFMA) as part of a broad effort by the financial industry to weaken the financial reform through lawsuits. Ira Hammerman, general counsel for SIFMA said the "court's ruling is entirely procedural, and was not a decision about the merits of [the] challenge or of [their] request for a stay." The case is likely to be refilled in district court soon.

OCC

Comptroller Walsh Contradicts Buffet on Need for Derivative Reform:

On January 24th, Acting Comptroller of the Currency John Walsh warned against the "misperception," which serves as the catalyst for derivatives reform, saying that the risks related to derivatives are overstated. "[T]he risk ascribed to derivatives is often many orders of magnitude greater than the reality," Walsh said at an American Securitization Forum conference in Las Vegas. Criticizing Buffets's famous description of the product as "financial instruments of mass destruction" Walsh indicated his believe that this characterizatioin is a vast overreaction and expressed his worry that a misperception could motivate redesign of the system. While acknowledging that the financial crisis "demonstrated the need to improve the regulation of derivatives," Walsh warned that rulemaking to address derivatives must "avoid making it more difficult for banks to manage their own risks and to serve the legitimate needs of their customers."

FINRA

FINRA to Propose Tighter Rules for Fixed Income Analysts:

US financial regulators are set to issue new rules to confront conflicts of interests in fixed income research by bringing bond market regulation in line with equity analysis. At the request of the SEC, staff at the Financial Industry Regulatory Authority (FINRA) will file new rules in the coming weeks for stricter rules over analysts who cover bonds. The initial proposal was published by FINRA in April, citing "increased retail investment risk in complex debt securities" and inadequate disclosures of fixed income conflicts. The final proposal will likely subject analysts writing fixed income reports to the same rules by which equity analysts currently abide.

UPCOMING HEARINGS

On Tuesday, January 31st at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing titled "Holding the Consumer Financial Protection Bureau (CFPB) Accountable: Review of First Semi-Annual Report."

On Tuesday, January 31st at 10am, in 215 Dirksen, the Senate Finance Committee will hold a hearing titled "Extenders and Tax Reform: Seeking Long-Term Solutions."

On Wednesday, February 1st at 10am, in 608 Dirksen, the Senate Budget Committee will hold a hearing on the outlook for the Eurozone.

On Wednesday, February 1st at 10am, in 428-A Russell, the Senate Small Business and Entrepreneurship Committee will hold a hearing on efforts to develop policies and strategies that encourage and strengthen high-growth entrepreneurship.

On Wednesday, February 1st at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity will hold a hearing on the efforts of the Department of Housing and Urban Development to implement the Manufactured Housing Improvement Act of 2000 (PL 106-569).

On Wednesday, February 1st at 10am, in 210 Cannon, the House Budget Committee will hold a hearing on the budget and economic outlook.

On Wednesday, February 1st at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on the Financial Institutions Examination Fairness and Reform Act (H.R. 3461).

On Thursday, February 2nd at 10am, in 608 Dirksen, the Senate Budget Committee will hold a hearing on the budget and economic outlook for the next ten years.

On Thursday, February 2nd at 10am, in 2360 Rayburn, the House Small Business Subcommittee on Agriculture, Energy and Trade will hold a hearing titled "The Future of the Family Farm: The Effect of Proposed Department of Labor Regulations on Small Business Producers."

On Thursday, February 2nd at 10am, in 210 Cannon, the House Budget Committee will hold a hearing titled "The State of the U.S. Economy."

On Thursday, February 2nd at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Oversight and Investigations will hold a hearing on the recent bankruptcy filing by the financial derivatives broker MF Global Holdings Ltd.

On Thursday, February 2nd at 1pm, in 2360 Rayburn, the House Small Business Committee will hold a hearing titled "The Path to Job Creation: The State of American Small Businesses."

On Tuesday, February 7th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity will markup a draft bill to overhaul programs of the Federal Housing Administration, focusing on affordable housing.

On Wednesday, February 8th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on legislation concerning accountability and transparency at the Consumer Financial Protection Bureau (CFPB).

On Wednesday, February 8th at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises will hold a hearing on legislative proposals that would limit the extraterritorial impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act (PL 111-203).