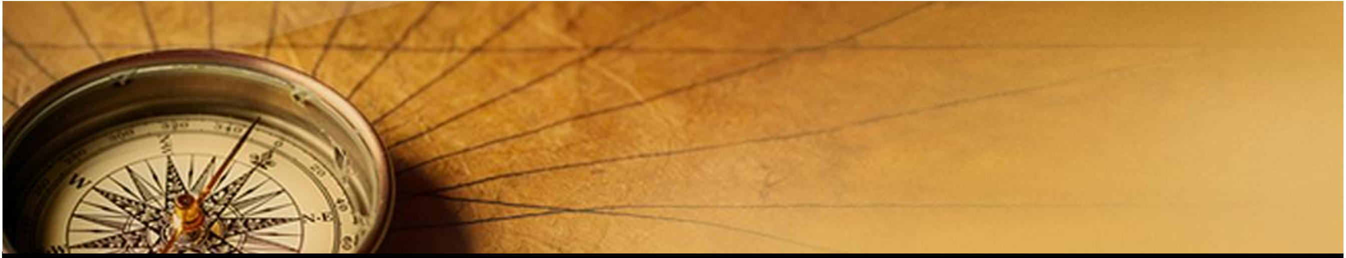

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FINANCIAL SERVICES LEGISLATIVE AND REGULATORY UPDATE

October 31, 2011

Leading the Past Week

While many American children will be celebrating Halloween later this evening, for the hedge fund industry the past week has already had its share of "trick or treats". First the industry was given a great big box of raisins (i.e., the worst thing to receive on Halloween) when the SEC adopted final fund adviser reporting rules that could potentially require funds to trust the government with critical proprietary information. Then came the news that European leaders had reached a deal to provide additional bail-out funds to Greece, though the sparseness of details and the potential reliance on Chinese money may come back to spook the market. Speaking of treats, the Obama Administration was handing out its own, both with the announcement of yet another plan intended to jumpstart the housing market and also with another plan to aide student lenders. Interestingly both plans rely almost entirely on Administrative action, evidence perhaps of a realization by the White House that little to no legislation – absent the Supercommittee and spending bills -- is moving through Congress this year.

Supercommittee Update:

While the Supercommittee continues to work behind the scenes, last week it also held its fourth public hearing on defense and non-defense discretionary outlays. While members of the Committee expressed optimism that a deal would be reached, they were cognizant of the approaching deadline to come up with a deal, with co-Chair Patty Murray (D-WA) saying despite much hard work they are "not there yet." Republicans and Democrats on the Committee appeared to agree that discretionary spending would have to be a part of a final package; however, Republicans took the opportunity to attack the 2009 Recovery Act while Democrats drove home that non-defense discretionary spending accounts for a relatively small portion of the overall budget. CBO Director Elmendorf, in his second appearance before the Committee, again urged the Committee to have a plan before the CBO by the beginning of November in order to give the CBO time to score their proposal and work with legislative counsel and Committee staff.

The day before the Supercommittee's public hearing, Senate Democrats presented their first proposal before the full committee. The plan would cut $3 trillion from the federal budget over ten years by cutting federal health programs and instituting up to $1.3 trillion in new tax revenues. Senator Max Baucus (D-MT) presented the deal to the Committee, calling for his colleagues to consider the deal as it takes up a plan where President Obama and Speaker Boehner left off last summer. Baucus reportedly also urged the Committee to include President Obama's request of up to $300 billion in additional stimulus. In response to the Democratic proposal, Republicans offered a $2.2 trillion proposal comprised solely of spending cuts and no new revenues. The Republican counter-offer would cut corporate and individual taxes, theoretically spurring economic growth to increase revenues by approximately $200 billion. The proposal also would also cut $1.2 trillion in spending selling government assets and cutting Medicare benefits and providers.

Both party's proposal gained traction with the other side, with Democrats calling the Republican proposal a "joke" and Republicans charging that any deal with new taxes is "not a serious proposal." The Center on Budget and Policy Priorities was also displeased with the Democratic plan, blasting it for moving far to the right of Bowles-Simpson and Gang of Six plans and saying the Republican rejection of the plan "dooms the chances that Congress will be able to pass a big, bipartisan plan." It has been reported that aides familiar with the Democratic proposal are also not optimistic for its success and others view it solely as political positioning for Democrats should Supercommittee fail to reach a deal.

Legislative Branch

House of Representatives

House Financial Services Marks Up Four Bills to Increase Access to Small Business Capital:
On October 26th, the House Financial Services Committee unanimously approved by voice vote four bills to aid small business in capital formation, including: the Access to Capital for Job Creators Act (H.R. 2940); the Private Company Flexibility and Growth Act (H.R. 2167); a bill to amend the securities laws to establish certain thresholds for shareholder registration, and for other purposes (H.R. 1965); and the Entrepreneur Access to Capital Act (H.R. 2930). Most of these bills are anticipated to be on the House floor next week.

During the mark-up the most contentious of the four bills was H.R. 2930, introduced by Representative Patrick McHenry (R-NC), which would create a regulatory exemption from SEC registration for companies using crowdfunding to raise up to $1 million dollars from investors who could contribute up to $10,000 or ten percent of their income. The Committee approved McHenry's bill with an amendment from Representative Steve Stivers (R-OH) to decrease the registration cap at $1 million rather than the $5 million cap originally included in the bill.

While small business capital measures have not received much attention in the Senate, Representative Jim Himes' (D-CT) H.R. 1925—which would increase the shareholder threshold (from 500 to 2,000) at which community banks are required to register with the SEC— will be considered on the House suspension calendar (reserved for non-controversial measures) this week, and HR 2940 and HR 2167 are expected to come up under regular order.

Ways and Means Chairman Introduces Territorial Tax Plan:
On October 26th, Representative Dave Camp (R-MI), Chairman of the Ways and Means Committee, released a tax plan to overhaul the way foreign earnings of multinational companies are taxed. The

proposal lowers rates on most foreign revenues from 35 percent to 5 percent if those earnings are brought back to the US as dividends—essentially a territorial tax system. Speaking on his plan, Camp noted that the US tax system is "out of step with the rest of the world" and "really penalizes companies that are doing business worldwide."

Camp stressed that lowering rates would not increase deficits because of an 8 year transitional measure to tax foreign earnings at 5.25 perfect regardless of whether revenues are brought back to the US. A 2007 Treasury report found that, if done properly, a territorial system could actually raise federal revues. While Ways and Means Ranking Member Sander Levin (D-MI) seems to be waiting for more details before passing judgment, Camp's plan was met with approval from industry groups such as the National Foreign Trade Council, who said a territorial tax rate "will allow companies to grow in the United States, and will also attract more in-bound investment, leading to more job growth."

American Lawmakers Apathetic Toward European Sovereign Debt Crisis:
While most eyes have been on European negotiations to provide relief to Greece and increase the scope of the EFSF, Congress has shied away from the European sovereign debt issue. Despite the fact that both Treasury Secretary Geithner and Federal Reserve Chairman Bernanke as well as other banking regulators have repeatedly warned legislators that the EU sovereign debt crisis is one of the greatest threats to US financial stability, the fact that (1) there is no obvious political advantage to entering the European debt debate, and (2) there isn't a lot that members of Congress can do to mitigate the problem has left American lawmakers to be content on the sidelines. At recent hearings on the debt crisis few lawmakers have attended. Most recently, at the House Financial Services International Monetary Policy Subcommittee hearing on the issue, Charles Collyns, Assistant Treasury Secretary for international finance, attempted to drive home the significance of sovereign debt to the few Members who attended. Collyns said: "any increase in volatility in market uncertainty about the financial institutions in the European core very quickly translate into increased uncertainty in U.S. financial markets, and you've seen that playing out over the last couple of months." (More on the European Debt Crisis can be found below).

Rep. Garrett Unveils new Proposal to get the Government out of the Mortgage Business:
On October 27th, Representative Scott Garrett (R-NJ), Chairman of the House Financial Services Capital Markets Subcommittee, unveiled a proposal to boost private sector investment and to eliminate the government guarantee in the secondary mortgage market. His plan calls for closing Fannie Mae and Freddie Mac, while empowering the Federal Housing Finance Administration (FHFA) to develop uniform underwriting standards for private home loans. Other provisions are designed to provide investors legal clarity in mediation and refinancing, along with ensuring added price transparency as a way to encourage their participation. The plan is ambitious, but likely faces roadblocks from other Republican members whose proposals call for reducing the government's role in the housing market while retaining some government guarantee.

Energy Commerce Subcommittee Hearing about Legalizing Internet Gambling:
On October 25th lawmakers on the House Energy and Commerce Manufacturing and Trade Subcommittee had a hearing about the potential legalization of online poker. Representative Joe Barton (R-TX)—who introduced the "Internet Gambling Prohibition, Poker Consumer Protection, and Strengthening UIGEA Act of 2011" (H.R. 2366)—and other Committee members made the argument that as many as 8 million Americans already engage in online gambling with little to no consumer protection and without the ability for the federal government to collect tax revenue. Other conservative

Republican Members remain skeptical of the proposal, with Rep. Gregg Harper (R-MS) saying that the argument for legalizing online gaming is the same as that for legalizing drug use. Witnesses cautioned the Committee of the possible risks of legalizing online gambling, such as bots, children and addiction; however, Parry Aftab of FairPlayUSA argued that "all of these issues can be dealt with by legalizing some aspects of online gambling and regulating it."

While her Subcommittee is divided, Chairman Mary Bono Mack (R-CA) has yet to indicate support for Barton's legislation. Among other things, her caution at endorsing the online gaming proposal may come from the presence of several Indian casinos in and around her congressional district and their concerns of the possibility of decreased patronage if an online presence is legalized. Bono Mack's office has said the Chairman plans to hold additional panels on the issue to hear from state gambling regulators.

Small Business Committee Examines Small Business Access to Credit:
On October 26th, the House Small Business Committee heard from the Small Business Administration (SBA) along with witnesses representing small business stakeholders on SBA's various financing and lending options. SBA Administrator Karen Mills told lawmakers that while SBA financing is back at pre-recession levels more must still be done to identify gaps in lending, where loans are not working and how to bring back private sector small business lending. A second panel comprised of small business lenders generally approved of SBA's programs but expressed concern over an uncertain regulatory environment, the debt and deficit debate and the limited amount of private lending.

Senate
While Volcker Indicates his Approval of Namesake Rule Republican Senator Continues his Critique:
On October 27th, Senator Bob Corker (R-TN) blasted the recently released Volcker Rule for its potential to cut off credit and limit capital, saying that when America is at the "height of the time when people are having trouble getting credit the Volcker rule comes out. People think it's about traders at banks making money gambling at banks. But at the end of the day, what it also affects credit throughout our country." Even as Corker criticized the rule, former Fed Chairman Paul Volcker was on the Charlie Rose show, where he not only squashed rumors that he was disappointed with the Administration's implementation of the rule that bears his name, but also implied that the so-called Volcker rule is significantly less stringent than the Glass Stegall restrictions, and therefore critics of his rule should be happy that "Volcker" is as lenient as it turned out to be.

Lawmakers Press Financial Regulators to Examine Bank of America's Derivatives Transfer:
Last week, Congressional Democrats sent letters to the FSOC, asking regulators to examine Bank of America's transfer of an unknown amount of derivatives from its subsidiary Merrill Lynch into a deposit taking subsidiary insured by the FDIC following Moody's downgrade of Bank of America. Eighteen lawmakers signed onto letters led by Representative Brad Miller (D-NC) and Senator Sherrod Brown (D-OH). Miller's letter pressed regulators to look to the quality of the transferred derivatives, the price of the portfolio and whether Bank of America made their risk models available to regulators at the time of the transfer. Brown's letter questioned whether the transfer was legal under Section 23A of the Federal Reserve Act, which restricts transactions between banks and their nonbank affiliates.

Senator Bernie Sanders (I-VT), who has long been an advocate for separating trading and commercial banking operations said the transfer is exemplary of the need to "break up too-big-to-fail financial behemoths." Representative Maurice Hinchey—a co-signer of the Miller letter and one of the 40 House

lawmakers who support reinstating the Glass-Stegall Act—took perhaps the harshest tone saying that Bank of America's actions simply should not have been legal.

Executive Branch

SEC

SEC Approves Final Hedge Fund Advisor Disclosure Rule:
On October 26th, the SEC unanimously adopted a rule to require hedge funds and other private funds to report information to the SEC which will be used by the Financial Stability Oversight Council ("FSOC") to make determinations of what constitutes a systemic risk in the financial system. In what can only be seen as a victory for the industry and its lobbyists, the final rule has been significantly modified from the initial proposal. Including amongst the changes are: higher reporting thresholds, changes to the amount of detail to be reported, reductions in the frequency of reports and extended compliance deadlines. The rule is a joint rulemaking effort by the SEC and the CFTC—which is expected to issue its final rule within a week of the SEC announcement. The SEC will delay posting its adopted rule until the CTFC has approved their final rule.

In brief, the final rule requires all registered private fund advisers with greater than $150 million in assets to file a new Form "PF". Most of the reporting burden falls to the largest hedge and liquidity fund advisers. Hedge funds with more than $1.5 billion in assets will be required to report quarterly on exposure, asset class turnover and concentration. Whereas liquidity funds managing over $1 billion will be required to report on the type of assets in funds' portfolios, risk profiles and compliance with the 1940 Investment Company Act. Private equity fund advisers with more than $2 billion in assets will be required to report yearly on their leverage, bridge financing use and investments in financial institutions.

Reporting thresholds were increased from the January proposal, according to Chairman Mary Schapiro, so as to target the most influential funds. However, while SEC threshold determinations are based only on US advisers, it is possible funds with marketing activities or investors linked to the US could be covered by the rule. The SEC also changed how assets are calculated when determining thresholds in two ways: 1) advisers will not be required to aggregate private fund assets managed by all affiliates but rather only those that are not operated separately; and 2) advisors will not be required to aggregate assets within separate accounts, even if they are managed as part of the private fund.

Commissioner Troy Paredes, who originally voted against the January rule, reversed course this week and voted for the final rule, which he saw as having been substantially improved. A sentiment echoed by Karen Barr, General Counsel at the Investment Adviser Association. However, not all of the impacted industry took a positive view of the rule. For example, Richard Baker, the CEO and President of the Managed Funds Association expressed his disappointment with portions of the rule, in particular the amount of data that his members will have to disclose along with the frequency with which they will have to disclose it.

Personnel Moves:
On October 27th, SEC named two individuals to the Division of Trading and Markets who are tasked with implementing key oversight aspects of the Dodd-Frank Act. Brian A. Bussey will serve as Associate Director for Derivates Policy and Trading Practices, while Peter J. Curely will serve as Associate Director for Clearance and Settlement – an office which regulates security-based swaps.

White House

President Announces Plan to Provide Relief for Underwater Mortgages:
On October 24th, President Obama announced new plans for the Federal Housing Finance Agency (FHFA) to aid homeowners who meet their mortgage payments, but who are unable to refinance to lower interest rates due to the declining value of their homes. The initiative will reform the Home Affordable Refinance Program (HARP) which was launched in 2009 to help 5 million homeowners refinance to lower, current interest rates if they had loans owned or guaranteed by Fannie Mae or Freddie Mac. By last August, less than one million homeowners had taken advantage of the program, as caps on mortgage size and expensive upfront refinancing fees excluded many homeowners.

The plan, which can be implemented without Congressional action, is similar to a bipartisan bill introduced by Senators Barbara Boxer (D-CA) and Johnny Isakson (R-GA) last January. It lifts the loan-to-value cap, which had limited refinancing to mortgages that did not exceed 125% of the current home value; it eliminates or reduces many upfront, risk-based fees; and, as with its previous iteration, it will be available to homeowners whose loans originated before May 31, 2009. The Administration also announced details on a plan to waive some risk based fees for borrowers refinancing to shorter term mortgages will be released on November 15th.

While some are skeptical what effect the plan will have on a market that includes 11 million underwater mortgages, Moody's Analytics projected that the revised program will help an additional 1.6 million homeowners refinance by the end of 2013. For those homeowners who are able to refinance, the revamped plan could mean avoiding foreclosure and saving on average $2,500 per year. Gene Sperling, Director of the National Economic Council, said the plan will "also will give a far greater incentive for the bank that currently holds the mortgage to preemptively offer these families a competitive rate that will help them."

Fed

Fed Approves Westpac Acquisition in First Test of New Dodd-Frank Mandates:
On October 24th, the Federal Reserve Board approved Westpac Banking Corp's bid to acquire JO Hambro Capital Management's (JOHCM) $11 billion investment management arm. This acquisition would give Westpac—Australia's third largest bank—control of JOHCM International Select, a US general partner. In approving the acquisition the Fed was careful to note that it offers "no view" on whether the business will still be legal once the Volcker Rule takes effect. The Westpac situation is the first test of the Fed's new Dodd-Frank mandate to consider whether financial stability will be threatened by an acquisition. Industry analysts are also looking at how the Fed engaged in the Westpac analysis with the hope that it will shed light on Capitol One's pending acquisition with ING Direct—which would make Capitol one the US's fifth largest banking institution.

<u>International</u>

To Relief of Markets, Euro Zone Leaders Strike Greek Deal with Banks:
Last week, European leaders from 17 euro zone countries agreed to an historic deal on Greek debt, convincing private banks and insurers to accept a 50 percent loss on Greek government bonds. The plan is worth €100 billion and is a 21 percent increase over the July 21st deal. The plan aims to lower Greece's debt to GDP ratio by 120 percent in 2020 and address the broader sovereign debt crisis. In

order for banks to accept a 50 percent loss in investments, EU leaders offered up "credit enhancements" on the order to €30 billion. Negotiations on a final deal are expected to wrap up by the end of the year with the goal of a Greek rescue package in action before 2012. The deal also places a ban on naked Credit Default Swaps (CDS) on sovereign debt. Not paying out CDS as part of the Greek deal could potentially undermine the market and the use of CDS as a hedge against sovereign debt.

In addition to a deal on a Greek rescue package, Euro zone leaders also agreed to increase the European Financial Stability Facility (EFSF). The EFSF will be operated through leveraging insurance guarantees to purchasers of European debt and through special purpose vehicles aimed at securing investments from China, Russia, Brazil and other sovereign wealth funds. European leaders are working to attract investments of up to €1 trillion from China by framing the fund as a potential investment. Klaus Regling, the CEO of the EFSF, is hopeful of Chinese participation in the Facility, as China has been a "good, loyal" purchaser of bonds recently. Chinese government officials have been quoted as saying their country will likely contribute to the EFSF but the scope of Chinese involvement is up for debate and may be conditional.

Markets responded soon after the stabilization deal was announced with the FTSE All World stock index increasing 4.1 percent—the largest one day rise since May 2010. Additionally, the S&P 500 rose 3.4 percent, representing the best monthly gain since October 1974. The White House also reacted to the deal, in a statement President Obama said the agreement is "an important first step" and he looks "forward to the full development and rapid implementation of their plan."

UPCOMING HEARINGS

On Monday, October 31st at 10am, in location TBD, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold a field hearing titled "Regulatory Reform: Examining How New Regulations are Impacting Financial Institutions, Small Businesses and Consumers."

On Tuesday, November 1st at 11am, in 2123 Rayburn, the Joint Select Deficit Reduction Committee will hold a hearing titled "Overview of Previous Debt Proposals."

On Tuesday, November 1st at 1pm, in 2360 Rayburn, the House Small Business Contracting and Workforce Subcommittee will hold a hearing titled "Protecting Small Business Contracting: Leadership Challenges at Four Cabinet-Level Agencies."

On Wednesday, November 2nd at 10am, in 2203 Rayburn, the House Oversight and Government Reform Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs will hold a hearing titled "America's Innovation Challenge: What Obstacles Do Entrepreneurs Face?"

On Wednesday, November 2nd at 10am, in 2318 Rayburn, the House Science, Space and Technology Subcommittee on Technology and Innovation will hold a hearing titled "Creating and Growing New Businesses: Fostering U.S. Innovation."

On Wednesday, November 2nd at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold a field hearing titled "The Consumer Financial Protection Bureau: The First 100 Days."

On Wednesday, November 2nd at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity will hold a joint hearing on possible incidences of fraud in the HOME Investment Partnerships Program of the Department of Housing and Urban Development.

On Thursday, November 3rd at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee (Chairman Johnson, D-S.D.) will hold a hearing titled "Empowering and Protecting Servicemembers, Veterans and their Families in the Consumer Financial Marketplace."