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FINANCIAL SERVICES REGULATORY REFORM UPDATE

February 11, 2011

The highlight of the past week was the overdue release of the Obama administration's recommendations for housing finance reform. Plans for dealing with Fannie Mae and Freddie Mac were conspicuously absent from Dodd-Frank financial regulatory reform when it was enacted last July, and since then legislators on both sides of the aisle have been eager to delve into the issue. We expect this issue, along with the implementation and oversight of the Dodd-Frank Act, to dominate much of the political discussion in the coming months. Although some of the most vocal legislators have attempted to polarize the issue, there does appear to be a general agreement that winding down the government-sponsored enterprises must be done gradually, so as not to upset the fragile and still-recovering economy. Additionally, this debate will pit a broad variety of political interests against each other and so this debate may not fall completely on purely partisan lines. That said, the continued role of the federal government in housing finance, however, remains a point of contention between some Democrats and Republicans. See below for more information on this topic.

In other news this week, the House Financial Services Committee continues to pound out hearing after hearing on a host of controversial financial policy issues. Notably, the Committee will meet to examine Title VII of Dodd-Frank, which seeks to regulate the substantial over-the-counter derivatives market in the U.S. Later in the day, the House Agriculture Committee (which has jurisdiction over the CFTC) will be examining the same issue.

This coming week will also see the roll out of the President's budget, which will have significant cuts for various domestic spending programs. It will be interesting to see what funding levels the administration proposes for the regulators tasked with implementing Dodd-Frank that rely on federal appropriations.

OBAMA ADMINISTRATION RELEASES ITS PROPOSAL FOR GSE REFORM

The White House's report to Congress, "Reforming America's Housing Finance Market," comprises 31 pages of recommendations, with short-term efforts focused on winding down Fannie Mae and Freddie Mac. Treasury Secretary Timothy Geithner stated that the wind-down process and creation of a new housing finance system will take up to seven years to complete. The administration took a middle-of-the-road approach in recommending neither complete privatization nor nationalization of the housing sector. Instead, the report offered three options with a narrow role for the federal government: limiting its support to the Federal Housing Administration; creating a system of government support that would only kick in during a financial crisis; or a continuous federal government support regardless of economic conditions.

In the report's introduction, the administration states that "Going forward, the government's primary role should be limited to robust oversight and consumer protection, targeted assistance for low- and moderate-income homeowners and renters, and carefully designed support for market stability and crisis response… this plan recognizes the fragile state of our housing market and is designed to ensure that reforms are implemented at a stable and measured pace to support economic recovery over the next several years."

REP. GARRETT SHARES HIS OBJECTIVES FOR GSE REFORM

Earlier this week, and in advance of the release of the Administration's proposal, Rep. Scott Garrett (R-NJ), the House Financial Service GSE Subcommittee Chairman, spoke again about his commitment to a "purely private U.S. mortgage market over time, free of any government subsidy or guarantee." Garrett spoke at the American Securitization Forum's annual conference on Monday, acknowledging that this will not happen easily or immediately. He outlined his "overarching objectives" for his proposed reforms: "protect the American taxpayer, end the bailouts, get private capital back in the housing market and mortgage market again and, finally, decrease government exposure to housing." Specifically, to accomplish these goals, Garrett emphasized selling off more of Fannie's and Freddie's assets, putting GSE costs on the federal budget to better account for their expense, lowering the upper limit for loans that GSEs can purchase or guarantee, and abolishing the GSEs' mandate to promote affordable housing.

Garrett's Subcommittee also held a hearing on GSE reform earlier this week, and more information about that hearing is available here.

SENATE BANKING COMMITTEE AGENDA LEAKED

In an internal memorandum to Senate Banking, Housing and Urban Affairs Committee members, Chairman Tim Johnson (D-SD) laid out his priorities for the coming term. He listed the three overarching areas of focus: oversight of Dodd-Frank, housing finance reform, and oversight of taxpayer investments in TARP and auto manufacturing. Unlike his Republican colleagues in the House of Representatives, Johnson indicated that he intends to ensure that financial regulators have sufficient funding to carry out their Dodd-Frank duties. In addition to the major issues outlined in Johnson's agenda, he also includes consumer financial products, financial data security, public transportation and infrastructure, and trade issues, as examples upon which Committee might want engage.

FDIC PROPOSE RULE TO RESTRICT BONUSES THAT INCENTIVIZE TOO MUCH RISK

As expected, and reported last week, the FDIC proposed rules on Monday that would prevent financial institutions from using big bonuses to incentivize executives to pursue short-term gains and take on large amounts of risk. Specifically, the proposed rule would require executives at banks with more than $1 billion in assets to defer at least half of their bonuses for at least three years. If actions by the executives during that three-year timeframe lead to losses, then the bonuses could be curtailed or eliminated entirely. The proposal would also have all firms establish strategies for deterring excessive compensation that rewards inappropriate risk-taking. Firms would be required to identify employees who could bring substantial risk to the firm in their individual capacities, and ensure that their compensation properly balances risk and reward.

This proposed rule was mandated by Dodd-Frank, and must be approved by other federal regulators before it is printed in the Federal Register and available for public comment.

FED PROPOSES DEFINITIONS OF SYSTEMICALLY SIGNIFICANT COMPANIES

As required under Dodd-Frank, the Federal Reserve proposed a rule earlier this week that would define "significant nonbank financial company," "significant bank holding company," and how to determine whether a company is "predominantly engaged in financial activities." Under the proposed rule companies would be considered "significant" if they have $50 billion or more in total consolidated assets, or are designated as such by the Financial Stability Oversight Council. These definitions will be central to federal regulators' ability to monitor the behavior of firms that were otherwise not under their jurisdiction.

Firms that fall under these definitions are expected to have greater scrutiny, and additional requirements to increase capital and liquidity standards.

FED ADOPTS FINAL REG WITH COMPLIANCE TIMELINES FOR VOLCKER RULE

On Wednesday, the Federal Reserve issued its final rule on the timeline for banks to comply with new restrictions on bank proprietary trading activities, which will be published shortly in the Federal Register and will go into effect on April 1, 2011. The Fed had initially proposed its "Volcker Rule" compliance timeline regs in November 2010, but made minor changes based on public comments before issuing the final version earlier this week. Importantly, the new rule will give banks two years to comply with the trading restrictions, and also allow for three single-year extensions in certain situations.

The actual Volcker Rule regulations (with the substance of the new restrictions, as opposed to a mere compliance timeline) are expected to be issued in mid-2012.

CFTC CHAIR TESTIFIES ON DODD-FRANK DERIVATIVES REGULATION

At a House Agriculture Committee hearing on Thursday, CFTC Chair Gary Gensler testified regarding the implementation of the derivations provisions of Dodd-Frank. The Chair of the Committee, Rep. Frank Lucas (R-OK) expressed concern that Gensler's agency is proposing rules that are "at odds with the statute or with congressional intent," specifically with regard to margin requirements for end-users' swap transactions. In response, Gensler stated that he is recommending that end-users not be required to post margin with entering into transactions with dealer counterparties.

Lucas also stated the concerns of derivatives market participants that the CFTC is moving too quickly in its Dodd-Frank rulemaking, which is prohibiting interested parties from significantly commenting on the proposals. The agency has proposed almost 40 rules since October, in keeping with the statute's requirements for final rules to be in place within one year of Dodd-Frank's enactment. Gensler responded that the CFTC has fulfilled the majority of its rulemaking requirements, but the agency is now in a "natural pause" that will allow staff to reflect and consider comments before finalizing rules. He added that the CFTC will not be able to meeting its Dodd-Frank-imposed deadline of July 15th for implementing all the final rules.

Gensler also stated that "the CFTC's current funding is far less than what is required to properly fulfill our significantly expanded mission… we will need significantly more staff resources and, very importantly, significantly more resources for technology." Additionally, he spoke about harmonizing U.S. financial regulations with foreign regulatory bodies, and stated his optimism for coordination. He noted that the U.S. and EU are quite aligned on the issues, though the EU is moving more slowly, and that the Japanese have already adopted derivatives regulation.

HOUSE FINANCIAL SERVICES COMMITTEE ALSO TO EXAMINE DERIVATIVES REGS

This Tuesday, February 15th at 10am, the House Financial Services Committee will hold a hearing titled "Assessing the Regulatory, Economic and Market Implications of the Dodd-Frank Derivatives Title." SEC Chair Mary Shapiro, CFTC Chair Gary Gensler and Federal Reserve Member Daniel Tarullo will all testify in the first panel. The second panel is comprised of industry representatives from the Coalition for Derivatives End-Users, the Depository Trust and Clearing Corporation, the Securities Industry and Financial Markets Association, and the Swaps and Derivatives Market Association, as well as a couple financial executives.

House Financial Services Chair Spencer Bachus (R-AL) stated in his hearing release that "requiring companies that did not cause nor contribute to the financial crisis to be treated like banks will unnecessarily remove capital from the economy. We will work to ensure that the derivatives title of Dodd-Frank does not force valuable capital to sit on the sidelines or create a patchwork regulatory regime leaving market participants with conflicting regulatory mandates." We expect the hearing to cover the impact of derivatives regulation on job creation, U.S. competitiveness and the overall economy; the establishment of capital and margin requirements for end-user (exempt from clearing); as well as the harmonization of these regulations internationally and whether the marketplace will shift overseas.

As a reminder, federal regulators have until July 15, 2011 to finalize these rules, which would then be effective as soon as 60 days later.

SEC PROPOSES RULE TO END OVER-RELIANCE ON CREDIT RATING AGENCIES

On Wednesday, the SEC voted unanimously to propose amendments to prior rules, as required by Dodd-Frank, that would remove the credit rating requirement for companies seeking to use short-form registration when registering securities for public sale. This is the first of many upcoming SEC proposals to remove references to credit ratings requirements, and to replace them with other criteria. In the agency's press release, Chair May Schapiro stated that "over-reliance on credit ratings has been one of the factors cited as contributing to the financial crisis," and that she looks forward to hearing from the impacted companies whether there are "alternative criteria" that would preserve the eligibility for short-form registration. Public comments on the proposal are due by March 28th.

COMMISSIONERS SPEAK ABOUT SEC SHORT-TERM PRIORITIES

At the Practicing Law Institute's annual "SEC Speaks" conference last week, Chair Mary Schapiro spoke about her work in the coming months, and her attempts to think "holistically" about structural issues in the finance world. She stated that the agency is looking at multiple proposals in the hopes of creating a "roadmap so we can see how things can fit together." She stated that the SEC will be considering a number of measures dealing with high-frequency traders and whether trading algorithms should be subject to appropriate rules and controls. She acknowledged that the SEC would miss some of its Dodd-Frank deadlines, and once again called for the agency to move to a self-funding model.

At the same event last week, SEC Commissioner Kathleen Casey also spoke, taking a largely different tack than her colleague Mary Schapiro. Casey voiced her concerns with rushed rulemaking in order to meet Dodd-Frank deadlines, and warned the SEC not to retroactively apply new rules under that statute. She also stated that the agency's insufficient funding was not so much an issue as "the natural limitations on the capacity of the Commission to thoroughly consider often novel and complicated rule proposals."

CFPB HEAD OF ENFORCEMENT TO TAKE AGGRESSIVE APPROACH

Richard Cordray, the head of enforcement at the Consumer Financial Protection Bureau, held his first interview earlier this week, since beginning his new job. Cordray spoke about the aggressive methods he will use as soon as the CFPB is officially open for business in July, similar to the approach he took in his former role as the Attorney General of the state of Ohio. Cordray plans to focus on mortgages, credit cards and student loans, but won't make any promises under the bureau sets its priorities and determines what problems exist. If the CFPB does not have a permanent director by July, some of its enforcement powers will be delayed, which may happen due to the number of Republicans in the Senate who oppose the existence of the new agency.

NEUGEBAUER PROPOSES MOVING THE CFPB INTO THE TREASURY

Rep. Randy Neugebauer (R-TX), one of the staunchest opponents of the new Consumer Financial Protection Bureau (CFPB), introduced legislation this week that would move the CFPB into the Treasury Department. The Consumer Financial Protection Act of 2011 would take away the CFPB's status as a standalone bureau, and would allow for greater congressional scrutiny of its operations and budget. Neugebauer stated on Thursday that

"Congress must have a say on the appropriation of taxpayer money funding this agency's operation" because of the "significant and perhaps over-regulating powers" of the CFPB. The new bureau is actually spared from Congress's annual appropriations process and will be funded by an independent stream of money set aside for the Federal Reserve. Many Republicans have also stated their concern about this funding mechanism because of the large amount of discretion granted to the CFPB to act against "unfair, deceptive and abusive" practices in the financial services industry.

SEC IG PLEADS FOR MORE FUNDING

Speaking before the House Appropriations Financial Services Subcommittee on Thursday, the SEC's Inspector General (H. David Kotz) stated that his agency may have to cut as many as 600 positions if funding were reduced to FY2008 levels. Kotz noted that the SEC is up against "some very heavily funded entities," and the Office of the IG has made some recommendations for the agency that would be difficult to implement without sufficient funding. In response, Subcommittee Chair Jo Ann Emerson (R-MO) stated that the SEC's annual budget has more than doubled since 2001, and yet it was unable to prevent the 2008 financial crisis or the Madoff Ponzi scheme. Funding the SEC has become highly politicized, with each side of the aisle having a very clear position on the issue. Ranking Member Jose Serrano (D-NY), spoke in the Commission's defense, asserting that it needs "robust funding" in order to carry out its new Dodd-Frank responsibilities.

HOUSE COMMITTEE MEETS TO EXAMINE LOOMING MUNICIPAL DEBT CRISIS AND CONSIDERS WHETHER STATES SHOULD BE AFFORDED BANKRUPTCY PROTECTION

On Wednesday, the House Government Oversight and Reform Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs held a hearing titled "State and Municipal Debt: The Coming Crisis." Specifically, the subcommittee focused on the benefits and detriments to state bankruptcy versus federal bailouts. Representatives from think tanks and academia spoke on the panel. Chairman Patrick McHenry (R-NC) stated that state and local spending has ballooned and greatly outpaced the rise in inflation. Though states say that more money would help them through this difficult economy time, the government has outgrown the capacity to pay for itself. McHenry was eager discuss how states came to this predicament, and to determine how to fix the problem. Ranking Member Mike Quigley (D-IL) spoke strongly against the idea of states declaring bankruptcy, and stated that the short-term fiscal problem will improve as the broader economy also improves. He also added that states should enact pension reform, and should continue to build infrastructure as investment for the local economy.

FITZPATRICK ASKS FOR HEARING ON THE REPEAL OF GLASS-STEAGALL

Rep. Mike Fitzpatrick (R-PA), a member of the House Financial Services Committee, spoke at a Chamber of Commerce event earlier this week in which he stated his interest in examining the repeal of the Glass-Steagall Act. Glass-Steagall was a Depression-Era law that enforced a separation between investment and commercial banking, but was repealed in 1999 as a key deregulatory act in the Republican Congress at the time. Fitzpatrick asserted the need for a hearing on Glass-Steagall, in order to "determine what impact the act, or the absence of the act, had on the financial crisis in 2008." He did not attempt to answer the question himself, but merely stated that "we need to be willing to ask the tough questions, and let the truth lead us." Other GOP members have strongly denied that repealing Glass-Steagall had anything to do with the financial crisis and we do not anticipate that Fitzpatrick will get his hearing.

THE ATLANTIC HOSTS CONFERENCE ON THE ECONOMY

On Wednesday, The Atlantic hosted a half-day conference titled "Finding Work, Finding Our Way: Building the Economy and Jobs of the Future." Highlights included interviews and panels with such individuals as Treasury Secretary Timothy Geithner, Sen. Orrin Hatch (R-UT) and Brian Deese (the Special Assistant to the President for

Economic Policy). Notably, Secretary Geithner emphasized the importance of funding education because of the disproportionate returns it brings to the overall economy. He was optimistic about the economy in general. He likes the idea of a repatriation idea for corporate funds, but only as part of a comprehensive tax package. In thinking about the long-term deficit, he believes that the U.S. can't afford tax cuts across the board – instead, tax reform must be accomplished in a revenue-neutral manner, which he believes he can convince some key industry players to support.

UPCOMING HEARINGS

On Monday, February 14th at 4pm, in 2141 Rayburn, the House Judiciary Subcommittee on Courts, Commercial and Administrative Law will hold a hearing entitled "The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter."

On Tuesday, February 15th at 10am, in 2128 Rayburn, the House Financial Services Committee will hold a hearing on the implementation of derivatives provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act.

On Tuesday, February 15th at 1pm, in 1300 Longworth, the House Agriculture Committee will hold a second hearing on the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (covering some of the activities of the CFTC).

On Tuesday, February 15th at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Oversight and Investigations will hold a hearing on the legal fees of government sponsored enterprises.

On Wednesday, February 16th at 10am, in 2128 Rayburn, the House Financial Services Committee will hold a hearing on the report issued by the Financial Crisis Inquiry Commission.

On Wednesday, February 16th at 1pm, in 2360 Rayburn, the House Small Business Committee will hold a hearing titled "Putting Americans Back to Work: the State of the Small Business Economy."

On Wednesday, February 16th at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity will hold a hearing on housing finance issues.

On Thursday, February 17th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on the proposal of the Federal Reserve System to regulate the fees charged by the banks and payment card networks (e.g., Visa and Mastercard) for processing debit card transactions.

On Thursday, February 17th at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing titled "Oversight of Dodd-Frank Implementation: A Progress Report by the Regulators at the Half-Year Mark." Scheduled to testify are the heads of the Federal Reserve, FDIC, SEC, CFTC and OCC.