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FINANCIAL SERVICES REGULATORY REFORM UPDATE

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Although the White House and Congressional leadership continue to debate the FY2011 budget, this past week both the House and Senate managed another stopgap funding measure to keep the government funded through April 8th. This buys Congress just three more weeks to negotiate the final spending levels through September 30th of this year, although both the House and Senate will be in recess next week. However, it is not clear how many more short term measures Congress will be able to enact, since the a growing number of conservatives in both Houses have expressed displeasure with these short term patches. Earlier this week, 54 GOP members, many of them freshman tea-party types, voted against the 3-week CR, which included an additional $6 billion in spending cuts, on top of the $4 billion previously approved.

Unfortunately, it seems that little progress has been made about how to craft a full year 2011 budget, with legislators and the White House negotiating not only on which programs to cut and how much to decrease the budget, but also on extraneous policy items including hot-button items like ending funding for Planned Parenthood or defunding the EPA from regulating Green House Gases (GHGs). Republicans want another $50 billion cut from the FY2011 budget, including zeroing out funding for the health care reform, certain student loan programs and environmental regulations. Senate Majority Harry Reid (D-NV), on the other hand, is pushing for tax increases and cuts in programs like farm subsidies, as an alternative. Despite the fact that it seems both sides may be worlds apart on these negotiations, we anticipate Congress being able to pass another short term CR that will take the government up to late April or early May, which happens to be when the United States government will hit its "debt ceiling." We expect that the vote for the debt ceiling will be paired with the full year budget, and it will pass (albeit by slim margins). Alternatively, the government would shut down and be precluded from issuing any more debt, which by all estimates would be a cataclysmic disaster for the economy.

PROPOSED LAWS BY HOUSE GOP TAKE AIM AT DODD-FRANK

On March 16, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises held a hearing to discuss five bills intended to target and dismantle discreet portions of the Dodd-Frank Act. Republicans have opted for a targeted, piece-mail approach that they believe has a better chance of getting portions of Dodd-Frank either relaxed or reversed, as opposed to a wholesale repeal, through the Senate. Although not in supportive of the strategy writ large, Chairman Frank has effectively voiced tepid support for going forward in this manner, having indicated that there may have been some overreach in the rush to get Dodd-Frank over the finish line.
The five measures the subcommittee heard about this week include:

1. A discussion draft of a bill to amend the definitions of "major swap participant" and "major security based swap participant," authored by Rep. Michael Grimm (R-NY).
2. A discussion draft of the Asset-Backed Market Stabilization Act, authored by Rep. Steve Stivers (R-OH), which would repeal section 939G of the Dodd-Frank Act and to restore SEC Rule 436(g) of the Securities Act of 1933 that was repealed by that section. Effectively, this draft bill would remove liability for credit rating agencies by obviating the need for entities registering with the SEC to obtain and file consent from a credit rating agency in order to disclose its rating of the security in question.
3. The Burdensome Data Collection Relief Act, introduced on Monday by Rep. Nan Hayworth (R-NY) and seven cosponsors, would repeal Section 953(b) of Dodd-Frank (which requires publicly traded companies to disclose the median annual total compensation of all employees).
4. The Small Business Capital Access and Job Preservation Act, introduced by Rep. Robert Hurt (R-VA), Rep. Jim Cooper (R-TN) and three cosponsors, would amend Section 203 of the Investment Advisers Act to exempt private equity fund advisers from Dodd-Frank registration requirements. These advisers would, however, be required to maintain and provide records to the SEC as necessary and appropriate in the protection of investors.
5. The Small Company Capital Formation Act of 2011, introduced on Monday by Rep. David Schweikart (R-AZ) and seven cosponsors, would amend Section 3(b) of the Securities Act of 1933 to increase the offering threshold for companies exempted from SEC regulation under Reg A from $5 million to $50 million. The bill would also require the SEC to review the offering minimum every two years, and if it decides not to increase the threshold then it must report to the House Financial Services and Senate Banking Committees with its reasoning.

In addition to the five bills examined by the House Financial Services Committee, Rep. Bachus (R-AL) introduced the Responsible Consumer Financial Protection Regulations Act of 2011, along with 28 bipartisan cosponsors. This bill would replace the Director of the CFPB with a five-person Commission. The commissioners would have to be nominated by the White House, confirmed by the Senate, and no more than three could be from the same political party. Republican legislators have expressed frustration with the amount of power that would be vested in the CFPB Director, since the inception of the concept in Dodd-Frank negotiations. The GOP is concerned that the CFPB will have insufficient accountability and oversight because it will be funded by the Fed, rather than the congressional appropriations process. At a hearing on CFPB oversight earlier this week, Special Advisor to the Treasury Elizabeth Warren countered that the Financial Stability Oversight Council will have veto power over any CFPB rulemaking, and that organization is comprised of the heads of all the federal financial regulators. Rep. Frank, the ranking member of the House Financial Services Committee, summed up his perspective on these efforts by saying that "[T]hey don't like the CFPB, but they're afraid to take it on."

BATTLE MOUNTS AGAINST INTERCHANGE FEE RULES

The banking industry continues to engage in is vociferous opposition to the proposed debit interchange fee rules. This past week Senators Jon Tester (D-MT) and Bob Corker (R-TN) introduced the Debit Interchange Fee Study Act on Tuesday, designed to delay the rule and require additional study prior to implementation, while Rep. Shelly Moore Capito (R-WV) and Rep. Debbie Wasserman Schultz (D-FL) introduced a similar bill in the House, the Consumers Payment System Protection Act, along with 41 bipartisan cosponsors. The House bill is slightly different than the Senate bill, but both would effectively delay the implementation of the Durbin amendment. However, success of either version of these bills moving forward in the Senate is seen as facing an uphill battle, unlikely, as the author of the Dodd-Frank

amendment for capping interchange fees and champion of the regulation, Sen. Durbin (D-IL), has made it clear he intends to stand in the way of quick passage.

In addition to the fight in Congress, proponents of overturning the Durbin Amendment have a case pending in a South Dakota district court, arguing that the amendment is unconstitutional because it takes property without just compensation or due process. The case has sought injunctive relief, though the courts have not yet granted it.

Finally, in what appears to be something of an inter-agency squabble, a recent letter to the Fed, from FDIC Chairman Bair also made a series of recommendations on how to improve the proposal. Bair said she is "extremely concerned about the proposed rule's impact on community banks and consumers" and called for rules on network affiliation to be less burdensome, for the inclusion of the costs of fraud prevention and strengthening the exemption for small institutions. Bair's letter follows a March 4 letter to the Fed by the Acting Comptroller of the Currency John Walsh who noted that the rule "has long-term safety and soundness consequences—for banks of all sizes—that are not compelled by the statute."

FSOC PROPOSES RULE TO DEFINE CERTAIN ENTITIES AS SYSTEMICALLY IMPORTANT

The Financial Stability Oversight Council (FSOC) requested comments on Thursday for further guidance on how to designate systemically important transfer systems, clearinghouses and payment operators. The FSOC proposed a rule that would involve a two-stage identification and designation process, with a preliminary screening followed by more in-depth analysis of each of the entities. Those being screened would be forewarned that they are potentially being designated as "systemically important," and would have an opportunity to challenge any findings. Once the rule is published in the Federal Register, interested parties will have 60 days to file their comments. Treasury Secretary Timothy Geithner expects to enact final rules in the spring, at the same time rules are finalized on designating nonbank financial institutions as systemic risks, when we expect that the FSOC will also be naming specific firms.

FEDERAL TRUTH IN LENDING RULE UNDER ATTACK FROM ALL SIDES

On Tuesday, House Financial Services Chair Spencer Bachus (R-AL) and 30 other House members sent a letter to the Fed, requesting that implementation of a final rule on mortgage originator compensation are delayed from their current April 1st effective date. Mortgage brokers and other industry players consider the rule, as written, to be "intentionally vague. The Bachus letter specifically states that the Fed has not provided proper written guidance for the Truth in Lending Act (TILA) regulation, finalized in August 2010. The rule bans mortgage broker compensation based on interest rates or other loan terms, and also bans brokers and originators who receive compensation from a consumer to also be compensated by a lender or another party. The goal of these rules is to keep brokers and originators from pushing borrowers to opt for pricier products in order to increase their compensation.

The House letter is similar to one sent by Senators Jon Tester (D-MT) and David Vitter (R-LA) last week, in which they argued that the Fed needs to conduct a more comprehensive study of the potential impacts of its rule on the "defense of foreclosure" provisions in Dodd-Frank Section 1413. The Senators asserted that the Fed rule combined with this Dodd-Frank provision could have a "devastating impact on the mortgage market as large lenders may be unwilling to take the risk of acquiring loans from community banks, mortgage bankers and brokers." The issue is also being argued in the U.S. District Court for the District of Columbia, where the National Association of Mortgage Brokers and the National Association

of Independent Housing Professionals asked for a preliminary injunction against implementation of the Fed's rules, for at least 12 months, at which point the CFPB would take over TILA and other consumer laws. The Small Business Administration's Office of Advocacy has also requested a delay in implementation because of insufficient guidance on compliance.

HOUSE COMMITTEES GRILL CFTC AND SEC CHAIRMEN ON BUDGET

The House Appropriations Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies, which has jurisdiction over the Commodity Futures Trading Commission (CFTC) met on Thursday to discuss the agency's proposed funding. Chairman Gary Gensler testified before the Subcommittee, stating that the CFTC will not be able to create new regulations for over-the-counter derivatives (as mandated by Dodd-Frank) if funding levels are cut. Even if funding remains at FY2010 levels as it has been, Gensler's agency will have insufficient resources to enforce the new rules.

The House recently passed H.R. 1, the Full Year Continuing Appropriations Act, which would reduce the CFTC's budget by $57 million. Gensler testified that a decrease of that size would require the agency to lay off two-thirds of its 680 employees. His budget request for FY2012 would increase funding by 82% over FY2012, to which Subcommittee Chair Jack Kingston (R-GA) responded "it's going to be a problem." Although Kingston "do[es]n't want to derail anything," he also expressed apprehension over the pace of rulemaking at the CFTC, a concern that is shared by House Agriculture Chairman Frank Lucas (R-OK) and Senate Agriculture Chairman Debbie Stabenow (D-MI). Kingston questioned Gensler on what the CFTC would be able to accomplish with unchanged funding, and offered to help prioritize the sequence of rulemaking at the agency. Kingston was concerned that the U.S. might get too far ahead of its international counterparts, which would cause many companies to move overseas, or create an opportunity for regulatory arbitrage while others get their rules up to speed.

On Tuesday, SEC Chairman Mary Schapiro also testified before the House Appropriations Subcommittee on Financial Services and General Government, with regard to the Commission's FY2012 Budget request. Schapiro said that the SEC will need all of the requested $1.4 billion Budget to meet its "core capabilities" and implement new rules. The budget proposal would constitute an approximate $264 million increase in funds over 2011 levels for the agency. Schapiro said: "Despite the growth of our responsibilities and market complexities, the SEC's resources have not kept pace."

Despite a general aversion to increasing the SEC's budget, Republican Congresswoman Jo Ann Emerson, chair of the Appropriations subcommittee which oversees the SEC, stood with Schapiro and opposed sending the SEC back to 2008 levels of funding. She agreed that the Commission has "a lot to do," and 2008 spending levels, as proposed by her Republican peers, are "too drastic for the SEC," although she ultimately indicated that she would defer to the will of Republican leadership as to the size of the SEC's final budget.

FED TO END QE2 IN JUNE 2012

On March 15, the Fed announced that it will be ending the $600 billion Quantitative Easing II in June of this year. The Fed said it will be ending the bond buying undertaken in an effort to keep interest rates low because the economy is on "firmer footing" and to avoid inflationary pressure. The Fed will still be targeting a near zero interest rate but is wary of possible inflation. The Fed statement noted that "the

prices of energy and other commodities are currently putting upward pressure on inflation." However, it did not alter its inflation predictions, saying: "longer-term inflation expectations have remained stable, and measures of underlying inflation have been trending downward."

FRANK INTRODUCES BILL TO FORCE BIG BANKS TO FUND HOUSING RELIEF

House Financial Services Ranking Member Barney Frank (D-MA) introduced a bill on Thursday that would require hedge funds and major financial institutions to fund housing relief programs. The Emergency Mortgage Relief and Neighborhood Stabilization Program Cost Recoupment Act of 2011 would have the Treasury assess $2.5 billion in fees from hedge funds with more than $10 billion in assets and other financial institutions with more than $50 billion in assets. Although the money would go into a general fund at the Treasury, Frank wants the cash to go towards the housing relief programs that Republicans are seeking to cut. The House has already passed three bills that would end housing programs, and a fourth (ending the Home Affordable Modification Program) is set to be debated on the House floor after recess. This proposal is similar to the bank tax that was knocked out of the final version of the Dodd-Frank measure, and its prognosis for enactment this year is not good.

FDIC VOTES TO APPROVE ORDERLY LIQUIDATION RULE

On Tuesday, the FDIC unanimously approved a proposed rule for winding down large financial firms without allowing them to fall into bankruptcy or necessitating a government bailout. The Dodd-Frank Act gives the FDIC the authority to dismantle a failing institution that has been deemed systemically important. Chairman Bair said they "want shareholders and creditors to understand that if their institution fails, they are on the hook for losses, not taxpayers."

Under this rule, the FDIC has the power to seize failing institutions, pay off creditors, reorganize the management and temporarily manage or shut down the firm in a process known as "orderly liquidation." The rule also calls for the development of standards to determine if an institution's executives are responsible for the failure and thus liable to repay past compensation. Rep. Barney Frank (D-MA) said this "clawback" provision is designed to make executives "take risks more into account." The rule also provides guidance as to how creditors can file claims, how they will be paid and gives priority to debts incurred after the government takes over a firm.

BANKING INDUSTRY UNHAPPY WITH PROPOSED SWAPS RULES

As the CFTC works on a final rule to regulate privately traded swaps markets, U.S. banks, including Bank of America, Citigroup and JPMorgan Chase, are putting up a fight. Specifically, lawyers at these firms have written to federal regulators, expressing concern with duplicative regulation, unnecessary cost and damage to their ability to compete in foreign market if they are forced to register in the U.S. for swaps conducted abroad. The Securities Industry and Financial Markets Association (SIFMA) are also arguing that overly-restrictive rules could cause U.S. swap dealers to move abroad. CFTC rules, as written, would mandate clearing for many swaps, in addition to setting capital, collateral, trading and reporting requirements. CFTC Chairman Gary Gensler stated that these rules, when finalized, could indeed apply to foreign swap activities if they affect U.S. commerce, but his agency is still making that determination before the rules become finalized. U.S. rules are expected to decrease profits made by swaps dealers, and for now it appears that EU rules will be less restrictive when they are enacted much later.

CFTC SAYS RULEMAKING AND IMPLEMENTATION COULD BE STAGGERED

Speaking at a Futures Industry Association conference earlier this week, CFTC Chair Gary Gensler stated that his agency is considering finalizing rules mandated by Dodd-Frank in three phases, and then implementing the rules in a more staggered manner. The CFTC has proposed 42 rules to date, and should complete the majority of its Dodd-Frank rulemaking by the end of April, with only a few exceptions for inter-agency rulemakings (*e.g.,* capital/margin requirements, product definitions and swaps supervision). Many have criticized the CFTC to carrying out the rulemaking process too swiftly, although Gensler has stated that he does not expect his agency to complete all the Dodd-Frank rulemaking by July 15th, as mandated by Congress. Implementation of these rules, on the other hand, is only required to be carried out *at least* 60 days after a rule is made final. The CFTC will be taking many considerations into account in setting implementation deadlines, and will not be basing the timeline on the dates on which rules are finalized.

Gensler also stated that the CFTC has grouped rule proposals into early, middle and late categories, based on the agency's priorities. He hopes to finalize the first in the near future, the second in the summer, and the third in late summer/fall. The early group will include "process rules" such as mandatory clearing and rule submissions from clearinghouses and exchanges. The middle group will have multiple clusters of rules, including conduct rules for clearinghouses, swap dealers, trading markets and data. The final group will include rules that require coordination with the SEC, as well as the disruptive trading practices interpretive order and product definitions.

GEITHNER TESTIFIES ON CFPB ROLE IN ROBO-SIGNING SETTLEMENTS

Treasury Secretary Timothy Geithner and Department of Housing and Urban Development Secretary Shaun Donovan testified on Tuesday before the Senate Banking Committee, in a hearing entitled "The Administration's Report to Congress: Reforming American's Housing Market." Notably, Geithner responded to concerns expressed previously by Senator Shelby and Rep. Spencer Bachus (R-AL) about the CFPB's role in a settlement with mortgage services for the "robo-signing" incident. Geithner explained that Special Advisor Elizabeth Warren and CFPB planning officials are aiding in settlement negotiations because the new bureau will have supervisory authority over the mortgage servicing industry beginning this July. However, because the CFPB has limited powers before then, Warren and other officials will not be part of a final deal. Iowa Attorney General Tom Miller, who is leading the coalition of attorneys general in negotiations, believes that a final settlement is not imminent but perhaps months and months away. On the other hand, Geithner reassured Senators at the Banking Committee hearing, however, that a settlement should be reached as quickly as possible so as to provide market certainty.

RUMORS FLOAT THAT WHITE HOUSE IS DIVIDED ON SOCIAL SECURITY

According to a Democratic policy expert with ties to the Administration's economic policy team, the White House is divided on Social Security reform. The President is being advised by two different camps, one with a political focus and the other with fiscal priorities. Reportedly, the political team is winning the debate, arguing that promoting benefit cuts would greatly hurt President Obama's 2012 reelection campaign. The White House economic team is arguing that benefit cuts would be less drastic if they took place under the Obama White House and that shoring up the fund will spur activity in bond markets and the overall economy. Secretary Geithner and other Treasury officials have argued that reform will boost market confidence.

A spokesperson for the White House denied that there is conflict in the Administration, saying: "The notion that the President's team is divided on our approach to this issue is flatly untrue. The president and his team are unified in the belief that the only way to reach consensus on strengthening Social Security for future generations is for Democrats and Republicans work together in a bipartisan way, and any suggestion to the contrary is simply false."

At a House Ways and Means hearing in February, Geithner said the Administration "will reject plans that slash benefits; that fail to protect current retirees, people with disabilities and the most vulnerable; or that subject Americans' retirement savings to the whims of the stock market." David Plouffe, a senior political advisor, has also made it clear that he is against any kind of cut to the program.

OBAMA ADMISSION VETTING NEW CFTC COMMISSIONER

Earlier this year, Michael Dunn, a Democratic commissioner of the CFTC, announced his retirement and the search has been under way for his replacement. Recently, reports indicate that the Obama administration has begun background checks on Mark Wetjen, a senior staff member in Senate Majority Leader Harry Reid's (D-NV) office. The open position is being watched closely, given the controversy involved in implementing Dodd-Frank regulation at the agency, and given Dunn's moderate stance on many issues – he has been known to side with Republicans on issues like setting position limits on the commodity derivatives markets. Wetjen is a lawyer from Nevada, and joined Reid's office in 2005 and was a key advisor in the negotiations leading up to Dodd-Frank and is said to be a "really smart, thoughtful guy." Wetjen could face an uphill confirmation battle in the Senate, not because of any personal animosity from Republicans, but because of the sensitivities surrounding the implementation of Dodd-Frank. .

CORPORATE TAX REFORM FACES SOME OBSTACLES

Legislative efforts are under way to decrease U.S. rates to make them more competitive with international peers, and to create incentives for businesses to stay or move to the U.S. Budgetary concerns already exist, and thus removing this source of revenue would have to be counterbalanced by removing a variety of other tax breaks, deductions and special incentives from the corporate tax code. The Obama administration has been working with Congress and meeting with stakeholders for several months, and the political will does appear to exist for these reforms. According to Treasury Secretary Tim Geithner, "we think we have a reasonable chance of getting people to come together."

The obstacles remain, however, in how the reforms are actually implemented: House Republicans and the Obama administration have different views on whether or not to include corporate tax reform in a larger legislative package along with individual tax reform. Rep. Dave Camp (R-MI), Chairman of the House Ways and Means Committee, feels strongly that conjoining individual and corporate tax reforms is necessary so as not to leave out pass through entities that are structured as private partnerships but are taxed at individual rates. Some insiders believe, however, that some major bargaining on fiscal policy may take place in the coming months in Congress and the Administration, in order to deal with the U.S budget deficit. The "Gang of Six" – six centrist Senators (Warner (D-VA), Chambliss (R-GA), Coburn (R-OK), Crapo (R-ID), Conrad (D-ND) and Durbin (D-IL)) who are working together on a bill to implement recommendations from the Bowles-Simpson deficit commission – are garnering attention and could be the vehicle that pushes corporate tax reform forward. More likely, however, no substantial movement will take place until after the 2012 elections.

UPCOMING HEARINGS

The House and Senate are in recess during the week of March 21st, and the hearing schedule will resume the following week.