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FINANCIAL SERVICES REGULATORY REFORM UPDATE

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Despite having avoided a shutdown of the federal government during the previous week, issues surrounding the federal government's budget continue to be at the front center of the news this week, as the FY12 budget and questions about how the Congress will raise the debt ceiling swirl around the Capitol.

On Thursday the President signed the FY11 budget keeping the government operating through the end of the fiscal year (September 30th). While at the same time the House was debating the budget plan authored by Budget Committee chairman Paul Ryan, which was passed by the House of Representatives on Friday, by a vote of 253-193. This was a near party-line vote with only four Republicans crossing the aisle to vote against a budget that allotted $1.019 trillion for non-emergency discretionary spending. The budget passed by the House also calls for $6.2 trillion in cuts over the next decade, revamping the tax code, and reforming Medicare and Medicaid, among other things. The plan is $102 billion less than the one proposed by President Obama. The House also beat back four other substitute budget plans, including those by the Democratic Party and the conservative Republican Study Committee.

Prior to the debate in the House, President Obama spoke at George Washington University week, where he presented an outline of his own major framework for addressing U.S. long-term debt and deficits. His plan would include reducing the deficit by $4 trillion through 2023, and a "debt failsafe" trigger that would automatically invoke almost-universal spending reductions (exempting key entitlement programs) if the projected debt-to-GDP ratio is not stabilized by 2014. Obama's proposal would cut non-security discretionary spending by $770 billion by 2023, and would also cut security spending by $400 billion by the same time. He called for closing loopholes in the tax code, and creating a system for individual taxpayers that is simpler and fairer. He also supports strengthening Social Security, though his framework rests on the premise that the program is not in crisis, nor a driver of short-term deficit problems. This is considered to be President's "opening bid" in the budget talks with Republicans in Congress, and the general consensus is that this speech was intended to serve both as a "pivot" for the President into the budget debate and to position himself in the political center in advance of his re-election efforts (which also and perhaps coincidentally took place this past week.)

While the House's FY2012 budget plan faces a grim future in the Democrat-controlled Senate, House GOP leadership has made it clear that that will not pass a "clean" debt ceiling bill, leading many to speculate that there will be a need to tie a vote on the debt ceiling to some type of legislation – whether it's the budget or a different proposal – that would make further cuts to government spending.

Interestingly, there is growing international scorn for how the US is handling its debt issue, with the International Monetary Fund delivering a stinging report that the U.S. lacks a "credible strategy" to stabilize its increasing public debt. The IMF went on to state that this creates a small but palpable threat of another global economic crisis and that the U.S. is the only advanced economy that increased its 2011 budget deficit, while the economy was growing fast enough to reduce borrowing. There is also a growing sense that Congress, and particularly elements of the Tea Party, is not moved (or perhaps does not believe the veracity) by the rhetoric of the IMF and the others that says that the failure to raise the debt ceiling will result in dire economic consequences. Cynically, one could argue that such ramifications would actually help the GOP since a continually improving economy only further strengthens President Obama's reelection efforts. However, as there were reports this week that Speaker Boehner was reaching out to Wall Street to gauge the impact of the US Treasury defaulting on its obligations, and so, despite concerns that there could be two votes on raising the limit, the general consensus is that the limit will be raised. While helpful, this will only shift the debate to the process, which given the delicate psychology of the bond market, could end up being just as important as the vote itself.

DEBT CEILING REFORMS DISCUSSED IN SENATE

With the Debt Ceiling issue quickly eclipsing all other news as the top headline, the Senate Finance Committee held a hearing on Wednesday to examine the issue and consider alternatives to the current system. Chairman Max Baucus (D-MT) summed up the problem concisely by noting that "this [debt limit] is a tactical nuclear bomb," with which legislators play games and engage in brinkmanship as the ceiling is approached. Sen. Dick Durbin (D-IL) and former Comptroller General David Walker both floated the idea of replacing the current numeric limit with a debt-to-gross domestic product ratio, which would trigger requisite policy changes if a certain percentage is reached. Walker noted that the current debt ceiling is an "arbitrary number," and stated his support for President Obama's fiscal responsibility commission recommendation that would have Congress adopt a 70% debt-to-GDP target by 2020. If that percentage is reached, consequences such as cuts in discretionary spending and temporary tax surcharges could ensue until the deficits decreased.

The Treasury has estimated that the current debt limit of $14.3 trillion will be reached by mid-May, but that the absolute drop-dead date for action is July 8, 2011. Interestingly, in addition to the various political pressures facing Congress on this issue, they are also working with a relatively unfriendly calendar, because absent eliminating already planned "district work periods" there are only a handful of weeks that both the House and Senate are in session between now and July 8th.

HOUSE FINANCIAL SERVICES OVERSIGHT AND INVESTIGATIONSSUBCOMMITTEE EXAMINES FINANCIAL STABILITY OVERSIGHT COUNCIL ("FSOC")

The House Financial Services Subcommittee on Oversight and Investigations held a hearing on Thursday to examine activities of the Financial Stability Oversight Council (FSOC) and the criteria the organization is using to designate systemically important financial institutions (SIFIs). Officials from the SEC, CFTC, FDIC, Treasury Department, Federal Reserve and Office of the Comptroller (OCC) of the Currency all testified before the Subcommittee, in addition to a representative from the National Association of Insurance Commissioners. After each of the witnesses spoke, subcommittee members from both sides of the aisle criticized the FSOC for not giving financial firms under its jurisdiction ample opportunity to comment for certain highly-impactful rules.

Although the FSOC was created by Dodd-Frank to serve as a "super regulator", tasked with making critical decisions about what constitutes a systemically important nonbank financial company, a systemically important financial market utilities and clearinghouses as well as resolving disputes between agencies and completing important studies as dictated by the Dodd-Frank Act, the majority of this hearing focused on how the FSOC was working to implement Section 113 of Dodd-Frank, which requires the FSOC to designate nonbank financial firms that pose a risk to U.S. financial stability. Because the designation of systematically important carries a whole host of reporting requirements and other burdens, it has becoming the scarlet letter for non-bank financial service businesses.

It was not surprising then that both Chairman Randy Neugebauer (R-TX) and Ranking Member Michael Capuano (D-MA) questioned the imprecise nature of the proposed rule, which seemingly restated the list of risk factors written into Dodd-Frank, without actually formulating specific criteria. Jeffrey Goldstein, the undersecretary for domestic finance at the Treasury Department, responded that the final regulation will offer significantly more clarity. This did not satisfy Capuano, who shot back that firms affected by the rulemaking (many of whom have never been regulated in this respect before) will not have the ability to meaningfully offer feedback to the FSOC. Additionally, and perhaps more importantly was the fact that CFTC Chair Gensler indicated his belief that the FSOC's initial list of systemically significant institutions should be a short one, making him the first member of the FSOC to go on record as favoring a selective approach to the designation procedure, as opposed to the more sweeping treatment that some have predicted the FSOC might apply.

A final rule is anticipated to be released in the coming weeks, though based on the clear bipartisan concern about this process there is a long-shot chance that the FSOC could delay its rulemaking slightly. A final rule under Section 113 is expected within weeks. Bank and bank holding companies with $50 billion in assets are generally considered to be already in the category of systemic institutions, though there is debate on the precise application of those provisions.

PROPOSED ASSET BACKED SECURITIES (ABS) RISK RETENTION RULES COME UNDER BIPARTISAN SCRUTINY AT HOUSE FINANCIAL SERVICES COMMITTEE HEARING

On Thursday, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises held a hearing entitled "Understanding the Implications and Consequences of the Proposed Rule on Risk Retention." There were two panels of witnesses, the first of which included officials from the Fed, SEC, FDIC, OCC, Federal Housing Administration and Federal Housing Finance Agency; the second of which included industry representatives from the Mortgage Bankers Association, the American Securitization Forum, CRE Finance Council, the Mortgage Insurance Companies of America, Loan Syndications and Trading Association, and the Center for Responsible Lending. Six of the financial regulators testifying before the subcommittee had proposed a rule in March that would require sponsors of mortgage-backed securities (MBS) and other asset classes to retain 5% of credit risk when securitizing the asset. An exemption would exist for "qualified residential mortgages," a term defined by the rule to be where the "qualified" borrowers put down 20% of the purchase price. The interagency rulemaking was required under Section 941 of Dodd-Frank.

Full Committee Ranking Member Barney Frank (D-MA) expressed his concern that 20% is "too high a number," and advocated for other methods of making loans safe for securitization. In the Senate, Senators Mary Landrieu (D-LA), Kay Hagan (D-NC) and Johnny Isakson (R-GA), principal legislators involved in the creation of Section 941, have echoed similar concerns and argue that the down payment standard will be too restrictive. Instead, they support requirements for strong credit scores, low debt-to-income ratios and other metrics to determine which borrowers are secure. Some of the regulators on the panel continued to defend the 20% down payment exemption, noting the strong correlation between lower down payments and higher mortgage default rates. Others were in favor of less restrictive but still effective tactics. The public still has opportunity to comment before the rule is finalized.

Additionally, industry panelists spoke about the concept of tailoring risk retention requirements to their asset classes, and the importance of restoring the commercial mortgage-backed securities (CMBS) market as a means of improving the commercial real estate industry. The representative from the Commercial Real Estate Finance Council in particular stated that about $1 trillion in CRE loans will need to be financed, which will be impossible without an operating CMBS market. He noted that the risk retention rules for non-residential securitizations won't go into effect for two years, and asked the regulators to consider extending the deadline (currently 60 days for the comment period) for that aspect of the rulemaking.

SEN. HATCH URGES TREASURY TO DELAY VOLCKER RULEMAKING

In a letter released April 11th to Treasury Secretary Geithner, Senator Orrin Hatch urged for a delay in the rulemaking and implementation of the Volcker Rule and other Dodd-Frank provisions. Hatch said that concerns over the competitiveness of the U.S. "demand delay of further implementation and rulemaking of Dodd-Frank Act provisions until and unless we receive assurances that international partners agree to adopt similar regulatory reforms." At the same time, the President and CEO of the Federal Reserve Bank of New York also addressed competitiveness concerns in remarks April 11th, saying regulatory reform should promote an even playing field.

In the letter, Hatch asked Geithner to answer a number of questions concerning coordination efforts between U.S. regulators and G20 nations. These questions focused not only on the Volcker Rule, but also on CFPB rulemaking and foreign bank regulators.

NEW DEMS PROPOSE 8 GSE REFORM PROPOSALS

The New Democrat Coalition, which is comprised of moderate, pro-growth Democratic Members of Congress, released its proposal for GSE reform on Thursday. The effort, led by Rep. Jim Himes (D-CT) and Gary Peters (D-MI), both of whom are members of the House Financial Services Committee, included a framework that would wind down Fannie Mae and Freddie Mac, and give the federal government only a limited role in oversight, protecting taxpayers against losses, and ensuring continued access to safe and affordable mortgage products. All 43 members of the New Dems caucus supported the proposal, which includes:

1. Preserving access to traditional mortgage products (e.g., the 30-year fixed rate mortgage);
2. Ensuring a robust private market;
3. Limiting taxpayer liability;
4. Accurately pricing risk;
5. Encouraging greater competition and deep liquidity;
6. Requiring sound underwriting;
7. Limiting issuer activity that would restrict access to traditional mortgage products; and
8. Producing a full range of housing options.

CFTC BOTH MISSING DEADLINES AND ACCUSED OF WORKING TOO QUICKLY

As the one-year anniversary of the enactment of Dodd-Frank approaches, so do many rulemaking deadlines imposed by the statute. According to CFTC officials, however, the agency will be missing the deadline for some of the 50 rules that it was charged with implementing. CFTC Chair Gary Gensler testified before the Senate Banking Committee earlier this week, and stated that he expects all 50 rules to be *proposed* by July 21st, but he does not expect them all to be finalized because of the short timeline and need for additional resources. Gensler nor CFTC Commissioner Scott O'Malia would specify a date by which all the rules would be finalized. Instead, Gensler stated that "we've had good ongoing dialogue with Congress and the staff at Congress and we're only going to take up final rules when we can sufficiently summarize the comments, get commissioner feedback, get other regulatory feedback … and then we'll move to the final rules over the course of the next months."

On the other hand, the CFTC is also coming under criticism for "plac[ing] speed over deliberation" in its implementation of Dodd-Frank, according to House Agriculture Subcommittee on General Farm Commodities and Risk Management Chair Michael Conaway (R-TX). At a hearing on the subject, Conaway accused the CFTC of ignoring congressional intent, failing to perform cost-benefit analysis, and "demonstrating a lack of regulatory focus." He gave examples of the CFTC exceeding its authority under Dodd-Frank, and stated his opposition to the Dodd-Frank deadlines that "simply do not give regulators the time to do this right."

CFTC PROPOSES RULES ON MARGIN REQUIREMENTS AND RECORDKEEPING

Much to the chagrin of those who believe the CFTC is acting hastily (see above), the agency released a couple of important proposed rules this week, as mandated by Dodd-Frank. The first proposal, which set a framework for margin requirements to be paid by non-bank swap dealers, major swap participants and their counterparties on uncleared swaps, was noteworthy in that it conspicuously excluded end users from the rulemaking. End users are non-financial commercial parties that use swaps for legitimate hedging of risk, and the industry was closely watching the CFTC to see whether they were swept into the same category as speculative swaps. This proposed rulemaking put to rest some of the greatest industry fears – many large U.S. companies were concerned that overly-restrictive margin requirements would tie up billions of dollars in collateral, hurting their businesses and the greater U.S. economy.

While end users will not be subject to margin requirements, the CFTC proposal does include "credit support arrangements" that end users and swap dealers or major swap participant counterparties must negotiate bilaterally depending on the situation. Some concern also exists about harmonization of the

CFTC's proposed rules, both with those that are eventually enacted abroad, but also with similar rules that were proposed by the FDIC.

The CFTC also announced on Tuesday that the commissioners voted to propose a rule that would establish swap data recordkeeping and reporting requirements for counterparties to swaps that were executed prior to Dodd-Frank's enactment. The rule also includes "transition swaps" that were transacted between the enactment and the future effective date of the relevant rule on recordkeeping and reporting.

FY2011 CONTINUING RESOLUTION INCLUDES INCREASE IN SEC/CFTC FUNDING

Despite concerns to the contrary, the CR signed by President Obama last week includes some noteworthy *increases* in funding for both the SEC and CFTC budgets, above FY2010 levels. Under the stopgap funding measure for the remainder of FY2011, the SEC budget would increase $74 million to $1.185 billion. Although not a setback to FY2008 levels as originally threatened, the amount is still considerably less than the $1.3 billion authorized by Dodd-Frank, and the $1.258 proposed by the White House. Similarly, the CFTC's funding will increase to $202.7 million from its FY2010 level of $168.8 million, avoiding the potential $112 million cut initially proposed by Republicans in February. Both agencies still argue that this is not a sufficient amount of funding to carry out Dodd-Frank and other responsibilities, but now that both chambers of Congress have approved the temporary budget, the financial regulators will have to make do until the fiscal year ends on September 30th.

SEC TO HOST ROUNDTABLE ON SYSTEMIC RISK IN MONEY MARKET MUTUAL FUNDS

On April 8, the SEC announced that the agency will be hosting a roundtable discussion on May 10, focusing on mitigating systemic risk in money market mutual funds. The roundtable is designed to facilitate debate on various measures including recommendations from the President's Working Group (PWG) report in October. The PWG recommended reform of money market funds stable net asset value and creating an emergency liquidity fund.

The panel participating in the discussion will include members of the Financial Stability Oversight Council (FSOC), money market fund sponsors, short-term debt issuers, investors and academics. The SEC said they are accepting comments in advance of the roundtable.

INDUSTRY REPS ASKS MSRB TO DELAY MUNI ADVISER RULEMAKING

In February, the Municipal Securities Rulemaking Board (MSRB), as directed by Section 975 of Dodd-Frank, issued two notices seeking comment on amendments that would extend its fair dealing rule to and impose a fiduciary duty on municipal advisers. In response, the MSRB has received a slew of letters, many of which argue that the MSRB proposed rules are premature and potentially in conflict with the SEC. Dodd-Frank requires that municipal advisers dually register with the SEC and MSRB, and the former proposed rules along these lines in December. The MSRB acknowledged in its proposal that the pending SEC proposal was not taken into account, and if the latter were to be adopted, the former proposal would be revised accordingly.

The American Bar Association (ABA) noted in its comment to the MSRB that there are new fiduciary duties being considered for market participants, including one for broker-dealers at the SEC, and one for certain ERISA advisers at the Labor Department. The SEC and CFTC are also jointly considering a heightened standard of care for swap dealers that advise municipal entities. The ABA argued in its letter that "because our members may serve in all these capacities, it would be wholly unworkable for them to attempt to comply with differing – and possibly competing – fiduciary duties while providing the same services." Others have encouraged the federal regulators to coordinate their efforts and take care not to create conflicting rules, a sentiment that has been consistent throughout much of the Dodd-Frank implementation process.

DOL CONSIDERING MORE EXEMPTIONS FOR FIDUCIARY DEFINITION

Labor Department Employee Benefits Security Administration ("EBSA") Secretary Phyllis Borzi said on April 8th that the DOL may consider issuing additional exemptions to the final revised definition of a fiduciary. Borzi said additional exemptions "certainly strike[ ] [her] as something that would be perfectly reasonable…to do and might give people in the regulated community some greater certainty."

The Department is examining a number of broker-dealer functions to determine if they will fit into existing exemptions from ERISA fiduciary obligations, or if certain fee or commission practices would require additional exemptions. One such new exemption could be prohibited transaction exemptions in the form of class or individual exemptions. Borzi spoke to the concern that many in the financial services industry feel about the changing regulatory environment and said DOL has "no interest in putting all the broker-dealers out of business or having them get no compensation."

CFPB TO DELAY CREDIT DATA COLLECTION REQUIREMENTS

The Consumer Financial Protection Bureau's (CFPB) General Counsel Leonard Kennedy announced April 11th that banks will not be required to collect information and report on credit applications of minority and women owned small business until the agency can implement final regulations. Section 1071 of the Dodd-Frank Act, which requires this data collection and submission, was scheduled to go into effect on July 21st. However, CFPB guidance on privacy and other issues will not be released until 2012.

The data collection is intended to guarantee that fair lending laws and regulations are adhered to. Kennedy said "given the sensitivity of the data at issue, we believe Congress intended that the Bureau first provide guidance regarding appropriate procedures, information safeguards, and privacy protections."

TECHNOLOGY INDUSTRY PRESSES FOR DELAY IN DURBIN INTERCHANGE RULE – THEN WALKS BACK ITS SUPPORT

On April 6th, TechNet (a technology industry association) sent a letter to the Senate urging for a delay of the implementation of the Durbin amendment until the security of debit card data can be guaranteed and announcing TechNet's support for Senator Tester's bill which would bar the Federal Reserve from interchange rulemaking for two years.

In the letter, TechNet claimed that interchange fees will hurt the security of financial information. The letter said "today, robust protection of financial data is the number one priority. But under the new regime, cost-savings will become the number one priority, a situation that could reduce the incentive for ongoing investments in security infrastructure." However, one week later TechNet sent a follow-up letter announcing that the association was actually neutral on Senator Tester's amendment. Apparently the association has members on both sides of the issue and had gotten out of front of those who support Durbin.

Although Congress did not take up Tester's proposal during this past work period, the interchange issue remains white hot and could be on the front burner again when Congress returns in May. Based on conversations with key Senators on this issue it looks as if the path to a possible compromise is being developed, though a lot of work remains before anything is brought forward to a vote.

UK COMMISSION PROPOSES ITS VERSION OF DODD-FRANK FINANCIAL REG REFORM LAW

At the begging to the week the big news coming from across the pond was that the United Kingdom's Independent Commission on Banking (known as "the Vickers Commission" because it is led by Sir John Vickers) issued is recommendations for financial regulatory reform measures. This proposal, which is set to finalized by September of this year, was not nearly as onerous as the banks had initially thought they would be. In fact, to the relief of many, the proposals move the UK closer in line with the United States' laws and regulations, particularly in its treatment of banks. The Vickers Commission had reportedly had considered forcing banks to divide their securities practices from their retail and commercial lending operations, but instead proposed that UK banks move their deposits, small business lending and payment systems all into a separate subsidiary, and increase the amount of capital that is held against these retail operations. The idea behind this subsidiary concept is that retail units would continue functioning in a financial crisis, even if commercial and banking operations are under water. Similarly, in the U.S., banks may only use a certain amount of deposits in their investment and commercial banking activities (although the UK would go one step further in instituting capital requirements – 10% of core tier one capital – for retail units).

The Vickers Commission proposals have political support within the UK, though experts are unsure whether other European Union countries would follow suit if and when the proposals are enacted into law. Some say that these requirements could ruin the "universal banking model" used by many multi-national banks, while others say that the UK will act as a model for other EU countries. Insiders did agree, however, that lenders and bankers will not be fleeing London as had initially been threatened – there is a belief that major financial institutions will determine their location on long-term prospects for growth and opportunity, both of which London will still hold.

UPCOMING HEARINGS

Both chambers of Congress will be in recess during the weeks of April 18th and April 25th. No hearings will be scheduled during this period, but the following hearings have been scheduled to resume when Congress is back in session the week of May 2nd.

On Tuesday, May 3rd at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises will mark up bills to promote job creation and capital formation.

On Wednesday, May 4th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will mark up bills to improve the Consumer Financial Protection Bureau.

On Thursday, May 5th at 10am, in 2128 Rayburn, the House Financial Services Committee will meet to receive the Treasury Department's annual report on the state of the international finance system.

On Wednesday, May 11th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Domestic Monetary Policy and Technology will hold a hearing on the Federal Reserve's compliance with the Dodd-Frank Act and the Freedom of Information Act.

On Wednesday, May 11th at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises will hold a hearing on a subject to be determined.

On Thursday, May 12th at 10am, in 2128 Rayburn, the House Financial Services Committee will meet to mark up bills to extend the deadline for implementation of the Dodd-Frank Act's provisions regarding derivatives; to reauthorize the National Flood Insurance Program; and to improve the Consumer Financial Protection Bureau.

On Friday, May 13th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Oversight and Investigations will hold a hearing on the Stanford Financial Ponzi scheme.