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FINANCIAL SERVICES LEGISLATIVE AND REGULATORY UPDATE

May 14, 2012

Leading the Past Week

What was heading to be a rather routine week of hearings and the continued implementation of Dodd-Frank was shaken by the end of the week news that JP Morgan had a $2 billion dollar trading lost. The news, which appeared, at least initially, to add fuel to the fire of proponents of the Volcker Rule, despite assurances that the trades would not have violated the proprietary trading ban as they were internal hedges, who called the loss a 'stark reminder' of the need to reign in the risky behavior of 'too big to fail banks.' Of course, we would be remiss if we failed to mention the other highlight of the week, which had to be the juxtaposition of the Housing passing legislation to eliminate the budget sequester created by last summer's debt ceiling deal while nearly simultaneously Fed Chairman Ben Bernanke was warning Senate Democrats about the dangers that will be caused by the failure of Congress to resolve the impending "fiscal cliff" the country is facing. And both of these events overshadowed the news that the Federal Reserve approved, for the first time, the purchase of as US Bank by a Chinese bank as Industrial and Commerce Bank of China (ICBC) purchased an 80% stake in Bank of East Asia.

Legislative Branch

Senate

Senate Banking Examines Orderly Liquidation, Volcker Rule, Bank Size

On May 9th, a sparsely attended Senate Banking hearing, ostensibly on curtailing federal assistance for financial institutions, turned into a forum for Paul Volcker to, among other things, seize center state and defend his eponymous rule.

During the hearing Volcker said the "risk of failure of 'large, interconnected firms' must be reduced, whether by reducing their size, curtailing their interconnections, or limiting their activities." Calling for prompt and orderly resolution processes for failed firms and highlighting difficulties banks have handling conflicts stemming from trading activities. Volcker detailed that

"key elements in the approach toward failures need to be broadly consistent among major financial centers in which the failing institutions have critical operations."
In addition, Volcker also touched on money market fund reform, saying he believed regulators should consider structural changes and stronger capital requirements and oversight.

Underscoring the need for orderly liquidation, Chairman of the Subcommittee on Financial Institutions and Consumer Protection, Sherrod Brown (D-OH) said that by the end of 2010, the top ten largest banks held 77 percent of total banking assets—compared to 68 percent in 2006. In connection with the hearing Senator Brown introduced S. 3048, a bill to cap the size of banks, limiting them to a 10 percent share of the total deposits and liabilities any one could hold and limiting the size of non-deposit liabilities at banks to 2 percent of U.S. GDP. Brown's bill is similar to a failed amendment introduced to the Dodd-Frank Act in 2010.

Schumer Asks SEC to Address Broker Routing Decision Conflicts
In response to a study released on Monday by Woodbine Associates that found that brokers may be costing investors as much as $5 billion in order routing practices due to use of factors other than "best execution," and which also concluded that the most likely reason for the routing decisions is a "pricing schema" designed to reward brokers with lower fees or higher rebates for greater share volume, Senator Charles Schumer (D-NY) wrote the SEC on Thursday to request the Commission to address the "major" conflicts of interest revealed in a recent study of US equity exchange performance.

Schumer's letter requested the SEC to examine routing practices to determine if they are indeed in the interest of customers and to ensure brokerages disclose the rebates and incentive payments they receive to rout securities transactions to their markets. Further, the letter urged the Commission "adopt robust disclosure standards to ensure that customers receive complete transparency with respect to execution of their orders, and full disclosure of any potential conflicts of interest." Although the SEC issued a concept release on equity market structures in January 2010, Schumer charged that the SEC has not improved practices or protected investors from conflicts in fee structures.

In response to Schumer's letter, SEC officials pointed to Regulation NMS Rule 606 which requires brokers to disclose, at the request of the customer, trading venues and the time of order execution for the previous six months. That rule also prohibits trading venues from executing orders at prices lower than elsewhere quoted.

Highway Bill Conferees Consider Pension Stabilization Fund Obligations
The Senate approved highway funding bill (S. 1813) contains pension-funding stabilization provision which would replace short-term interest rate assumptions established by the Pension Protection Act with longer-term historical interest rates. House and Senate conferees met May 8th to consider the provision, which is not included in the House version of the funding bill. Stakeholders are concerned that rates established under the Pension Protection Act are throwing off actuarial assumptions used to calculate pension obligations and creating volatility. The Senate provision allows single-employer defined benefit plan sponsors to calculate funding obligations

using a 10 percent interest rate corridor with a 6.42 percent floor and a 7.85 percent ceiling. The American Benefits Council has said the provision would help enable employers to keep their pension plans fully funded.

Flood Insurance Deadline Nears, Calls for Extension Begin
On May 9th, the Senate Banking Subcommittee on Economic Policy held a hearing to consider the looming expiration of the National Flood Insurance Program (NFIP). The Chairman of the Subcommittee, Jon Tester (D-MT) is the sponsor of a bipartisan plan to extend the program through 2012; however, in the hearing he called on Congress to seek a long-term reauthorization. The last full reauthorization of the NFIP was in 2004, since it has continued through a series of short-term extensions. Industry groups, such as the Property Casualty Insurers Association of America, Realtors and the ABA has all expressed support for a long-term extension in addition to structured fiscal reform.

House of Representatives
Speaker Boehner Expects Vote on 2001, 2003 Tax Cuts Over Summer
In televised interviews on May 9th, House Speaker John Boehner (R-OH) said legislation to extend the 2001 and 2003 tax cuts through at least 2013 is expected to come to the House floor this summer. At this point it is unclear if the House legislation will be a simple one year extension of the current tax rates or if it will be a permanent extension of the cuts. Senate Majority Leader Harry Reid (D-NV) has also said he wants to bring a bill to the floor to extend the cuts; however, with higher tax rates for those earning over $200,000. As this bill is currently being blocked by Senate Republicans, Reid says he does not expect a vote before the November elections. In other remarks, Boehner expressed a desire to continue work on a tax code overhaul that would include decreasing the corporate rate to 25 percent and eliminating certain tax expenditures.

House Passes Ex-Im Reauthorization, Stalls in Senate
On May 9th, the House, by a vote of 330-93, passed the Securing American Jobs Through Exports Act (H.R. 2072), which would provide for a three year extension of the Ex-Im Bank authorization and a forty percent increase in its loan exposure cap, raising it from $100 billion to $140 billion. Despite the overwhelming House vote, and Majority Leader Reid's plans for quick action, the bill has bogged down in the Senate. According to published reports, Republicans are demanding consideration of five amendments to the reauthorization, including proposals to address financing for transactions subsidized by export credit agencies, prohibitions on funds for energy development outside of the U.S., and limits on Export-Import support. Senator Jon Kyl (R-AZ) has said that the amendments' sponsors would be amiable to short-term agreements to speed consideration of the bill. The Ex-Im Bank is expected to reach its $100 billion lending cap and have its charter expire at the end of May barring Congressional action.

House Financial Services Hears From Small Banks on Regulatory Burdens
On May 8th, the House Financial Services Subcommittee held a hearing to investigate how smaller banks and credit unions are dealing with regulatory burdens. One witness, Adam Levitin, a Georgetown University Law Professor, told lawmakers that the plight of these small

institutions has building for years, and has little to do with the Dodd-Frank Act. Levitin continued, financial regulations pose proportionally bigger burdens to small banks and giving small banks regulatory relief would only amount to "nibbling around the edges" of the true problem of too big to fail. Witnesses from a community bank and credit unions disagreed with Levitin, claiming Dodd-Frank has significantly increased the burdens faced by small banking institutions.

Still, Samuel Vallandingham, testifying on behalf of the ICBA, agreed that too big to fail institutions must be reigned in for the benefit of small banks. However, Vallandingham also warned against looming Dodd-Frank regulations that could impose new burdens, such as Section 941, which would require mortgage originators to retain credit risk on nonqualified residential mortgages. The ICBA is urging a broad interpretation of 'qualified residential mortgage' so as to avoid driving community banks and other lenders from the market. William Grant, testifying on behalf of the American Bankers Association, raised additional Dodd-Frank concerns such as the cost of regulatory compliance and the uncertainty of Dodd-Frank regulation.

House Adopts Amendment to Restrict DOJ Action in MBS Settlements

On May 8th, the House adopted an amendment to the Commerce, Justice, Science and Related Agencies Appropriations Act of 2013 (H.R. 5326) which would prohibit the Justice Department from being party to a settlement in which funds are removed from a residential mortgage-backed securitization trust. The language, offered by Representative Scott Garrett (R-NJ), was approved in a 238 to 185 vote. Garrett said his amendment would protect private investors who fund the mortgage market, citing that investors in mortgage backed securities were excluded from a landmark mortgage settlement announced in February. Garrett said the amendment would also protect investors such as state retirement systems, 401(k) plans, public and private pension plans, insurance company annuities and mutual funds by ensuring the Justice Department does not interfere with investors' right to due process. It is unlikely Senator Barbara Mikulski (D-MD), Chairman of the Senate Commerce, Justice, Science and Related Agencies Subcommittee, will include a similar provision in the Senate appropriations bill.

Financial Services Committee Hears Proposals to Change Scope of Fed

On May 8th, the House Financial Services Subcommittee on Domestic Monetary Policy and Technology held a hearing on improving the Federal Reserve System. During which, two members of Congress, Representatives Kevin Brady (R-TX) and Barney Frank (D-MA), were among the witnesses, each touting the need for the subcommittee to consider their respective legislation. Brady's legislation, the Sound Dollar Act (H.R. 4180), would limit the Federal Reserve's focus to inflation, as the dual mandate for price stability and maximum employment 'does not make sense.' Brady added, except in the very near-term, monetary policy cannot boost economic output to create jobs. Democrats and other witnesses reminded supporters of H.R. 4180 that accommodative monetary policy helped to prevent a deeper recession. Representative Frank also criticized a provision of Brady's bill that would change the Fed's policymaking panel, the FOMC, to include all 12 regional Fed presidents.

On the other hand, Representative Frank laid out H.R. 1512, which would put the 12 regional Fed presidents under the White House appointment process. Frank testified that the bill would limit undue private sector influence on the Fed, considering all current Fed presidents are voted into the position by business interests in the geographic area they represent. Frank bemoaned the "undemocratic nature" of this process. Opponents of Frank's bill charge it would limit regional diversity and representation.

Discussion of the Brady and Frank bills was part of a broader hearing on Subcommittee Chairman Ron Paul's (R-TX) legislation (H.R. 1094) to abolish the Federal Reserve. Several witnesses supported Paul's measure, calling for a return to the gold standard and calling the Fed's mission impossible; however, former Fed Governor Alice Rivlin, also a witness, called the idea of abolishing the US central bank strange. A spokesperson for the Financial Services Committee Chairman Spencer Bachus (R-AL) said no action is scheduled on the Brady or Frank bill.

House Budget Committee Passes Sequester Replacement Act with Cuts to Dodd-Frank Overhauls
The budget bill, which passed the House by a vote of 218 to 199, with 16 Republicans and all Democrats voting no, including numerous cuts of interest to the financial services industry. Including, the FDIC's orderly liquidation authority would be repealed, the Office of Financial Research abolished, the CFPB's budget would be decreases and brought under the normal appropriations process and fees on the financial services industry would be reduced by over $22 billion. The CBO has scored the orderly liquidation repeal as saving over $22 billion over ten years—though the scenario assumes a future financial crisis where Treasury funds would be tapped. In the event there is not future crisis the savings would never materialize.

House Democrats Introduce Bill to Limit Speculation in Energy Commodities
On April 27th, Representative Ed Markey (D-MA) introduced H.R. 5186, the Halt Index Trading of Energy Commodities Act. The bill would reduce excessive speculation through limiting commodity index funds' investments in energy commodities. Referred to the Agriculture Committee, the legislation would prohibit commodity index funds from investing in an energy commodity or participating in transactions involving energy commodities if any person in the fund is an "excluded investor" under the Commodity Exchange Act. Excluded investors would be any party not considered a legitimate hedger. Currently, the legislation has only Democratic cosponsors. Although Ranking Member of House Financial Services Barney Frank (D-MA) is among the cosponsors, there is little chance the Agriculture Committee will move the bill.

House Financial Services Holds Hearing on SEC Conflict Minerals Rule
On May 10th, at a House Financial Services International Monetary Policy and Trade Subcommittee hearing, experts testified that the SEC's rulemaking to require disclosure of the use of conflict minerals will not help stem human rights abuses in the Democratic Republic of the Congo. One witness, Mvemba Phezo Dizolele, a fellow at the Hoover Institution on War, Revolution, and Peace, testified that Section 1502 "oversimplifies the problem." The SEC rulemaking in question corresponds with Dodd-Frank Section 1502, requiring companies to disclose if any minerals used in their products originate in the DRC, or an adjoining country, and

to monitor mineral supply chains. The goal of the Section is to curb funding of armed groups that bankroll their activities and human rights violations through such minerals.

Some lawmakers focused their concerns on how much the rule would cost industry. Witness Bruce Calder of Claigan Environmental told the panel that the "biggest cost driver" is delay in the rulemaking—the SEC has put off finalizing the rule due to industry pushback. The cost of Section 1502 has been estimated by the SEC to cost industry approximately $71 million. Whereas Tulane University has put the price tad at $7 billion and the National Association of Manufacturers estimated costs between $9 billion and $16 billion. Whatever the costs may be, Representative Maxine Waters (D-CA), appeared at the hearing, expressing unwavering support for the provision.

Executive Branch

Treasury

Regulators Publish Guidance on Effective Date of Swaps Push Out Rule

On May 10th, the OCC, Fed and FDIC jointly issued guidance on Section 716 of the Dodd-Frank Act, the swaps push-out rule. Section 716, bans the provision of federal assistance to entities defined as swaps entities with respect to any swap, security based swap or other swaps entity. The rule encourages banks to spin off their derivatives trading by denying access to federal assistance, such as the Fed discount window or FDIC protection. The May 10th guidance clarifies that the Section 716 restrictions on swaps trading will not become effective until the summer of 2013, and not sooner.

The effective date of the swaps rule has been a concern to the banking industry and regulators have come under fire from banks for confusing language over the effective date and the possibility it would impact banks' ability to hedge. The guidance clarifies that, "because section 716 specifically adopts an effective date that is 2 years following the effective date of the Wall Street Transparency and Accountability Act, section 716 will become effective on July 16, 2013." Additionally, the House Financial Services Committee has approved H.R. 1838 which would modify the 'push-out- portion of Section 716, allowing banks to continue to trade swaps on equity, commodities and some credit default swaps, if done for the purpose of hedging risk.

FDIC

FDIC Outlines Plans for Orderly Liquidation of Failed Banks

On May 10th, Acting Chairman Martin Gruenberg outlined the FDIC's strategy for unwinding failing systemically important financial institutions (SIFIs), with resolution activities focused on collapsing bank holding companies and maintaining operational integrity of subsidiaries. Gruenberg said the FDIC's strategy in this area continues to evolve; however, orderly resolution will revolve around the goals of: stability of the financial system; accountability to ensure SIFI investors bear losses; and viability to ensure the distressed SIFI becomes a stable, well-capitalized entity through public receivership. These goals would be reflected in a receivership process for bank holding companies, allowing continued operation of both domestic and foreign subsidiaries. Specifically, holding companies placed into receivership would pass through an

FDIC owned "bridge holding company," permitting subsidiaries to operate while a new organizational and managerial structure is implemented.

In his remarks, Gruenberg recognized skepticism over the FDIC's "operational capacity" to draft and deploy a credible strategy for orderly unwinding of large, complex institutions such as Lehman Brothers. However, stressed that FDIC has devoted itself to the issue for two years and can demonstrate a strategy for resolution in the event of a financial crisis. Gruenberg also outlined other aspects of the strategy, including:

- How equity claims of shareholders and unsubordinated and unsecured debt holders would be left behind in receivership;
- That there would be a strong capital base for the bridge holding company;
- How the remaining claims of debt holders would be converted to equity claims and used to capitalize the new company, remaining claims would be transferred to the new firm as unsecured debt;
- How the bridge holding company may access the Dodd-Frank Orderly Liquidation Fund, and
- How the bridge will transition into a new private entity after a certain capitalization level and governance structure is achieved.

Finally, Gruenberg noted that the FDIC continues to work closely with international partners on cooperative resolution strategies—as failure of a SIFI would likely have impacts in foreign jurisdictions.

CFPB

CFPB Will Propose Rules on Mortgage Loan Originators

On May 9th, the CFPB outlined proposals designed to overhaul the market for new mortgage loans with the goal of bringing greater transparency to the mortgage loan origination market. The rules lay out possible limits on discount points and fees paid by borrowers, potential changes to compensation and qualification standards for brokers and loan officers. Following the announcement, a senior CFPB official said the Bureau expects the proposed rules to be issued over the summer and the rules to be finalized in late 2012 or early 2013.

Specifically, the CFPB is considering flat origination fees, a mandatory loan rate deduction if borrowers pay discount points, and requiring originators to present borrowers with the option of loans without discount points. New rules would require lenders to provide the interest rate reduction if points are paid. The CFPB is also considering qualification and screening standards for loan brokers and officers—including character and fitness requirements and background checks—in addition to a compensation ban for loan originators based on interest rates or specific other loan terms. Finally, while the rules would prohibit lenders from offering origination fees that are related to the size of the loan, it would allow a flat rate origination fee.

CFTC

CFTC Approves Designated Contract Markets Rule:

On May 10th, the CFTC unanimously adopted a rule to implement 23 core principles related to the operation of designated contract markets (DCM). The rule, mandated by Dodd-Frank, codifies prior guidance, regulations and accepted practices into a basis for obtaining and preserving status as a DCM. The final rule differs in several ways from the proposed rule—which two Commissioners voted down and a third (retired) Commissioner expressed strong dissent on. Notably, the final rule reflects a stronger principles-based oversight structure over the proposed rule. The final rule encompasses 23 core principles—five new and 18 existing, amended principles. The new principles address disciplinary procedures, system safeguards, financial resources, diversity of boards and the Securities and Exchange Commission. The rule also deals with resources, trading, and product requirements, compliance and surveillance obligations and operational capabilities.

In adopting the DCM rule, the Commission put off consideration of one proposed core principle—a contentious provision which would force a DCM to delist a futures of swaps contract that did not maintain a total volume of 85 percent on the DCM's centralized market. Meanwhile, also on May 10th, the CFTC proposed granting a provisional six month extension of compliance with certain provisions of the Commodity Exchange Act that were modified by Dodd-Frank. The extension would run to the end of 2012, or until the CFTC's Dodd-Frank rules go into effect.

SEC

Waters Throws Support to SEC User Fees

Speaking before the North American Securities Administrators Associations (NASAA), Representative Maxine Waters (D-CA)—the presumptive top Democrat on the Financial Services Committee next Congress— said the "best option" for investment adviser oversight is for the SEC to impose user fees on the industry as opposed to creating self-regulatory organizations (SROs). Waters' remarks come soon after Committee Chairman Spencer Bachus (R-AL) and Representative Carolyn McCarthy (D-NY) introduced H.R. 4624 to bring investment advisors under the purview under one or more self-regulatory organizations. While NASAA opposed the legislation, Waters called the bill a "good faith attempt" to oversee an "under-scrutinized" industry. Waters did convey several concerns with the Bachus-McCarthy bill such as the cost of SEC oversight of the SROs and the 'nationalizing' of regulation after Dodd-Frank expanded state regulatory roles.

SEC Issues Guidance on JOBS Act Crowdfunding Provisions

On May 7th, the SEC Division of Trading and Markets issued guidance on crowdfunding provisions of the Jumpstart Our Business Startups Act (H.R. 3606). The guidance includes insight into what entities will be required to register with the Commission and the Financial Industry Regulatory Authority (FINRA). The guidance also clarified that before a potential crowdfunding intermediary may register as a broker or funding portal, the SEC must first finalize rules to implement crowdfunding provisions. The guidance was issued in the form of FAQs, coming soon after guidance issued by the Division of Corporation Finance to clarify the SEC's position on the capital formation statute.

Title III of the JOBS Act directs the SEC to draft rules to implement the crowdfunding requirements within 270 of the April 5th enactment:, which translates to December 30, 2012. However, the regulations must carve out a new registration exemption for crowdfunding and once the rules are finalized funding portals will be subject to SEC examination, enforcement and rulemaking authority. Until that time, the Division of Trading and Markets have warned portals that the JOBS Act bars them from certain activities such as investment advice or solicitation.

The SEC guidance comes the same day as remarks by SEC Commissioner Luis Aguilar at NASAA's annual conference on federal and state regulation. Aguilar said the SEC will design the rulemaking process on the crowdfunding provisions of the JOBS Act with input from the NASAA from the beginning. NASAA has been critical of the JOBS Act, expressing fears it will eliminate investor protections and reduce transparency.

SEC Commissioner Stresses Need for Cost-Benefit Analyses in Rulemakings:
On May 1st, SEC Commissioner Daniel Gallagher stressed the importance of rigorous cost-benefit analyses in rulemaking, specifically on rulemakings to implement the JOBS Act. Under recent internal guidance, the SEC's Division of Risk, Strategy and Financial Innovation "must now be engages from the very earliest stages of policy formulation through proposal and adoption of any rule." The guidance further requires the SEC to "consider seriously the policy and institutional disincentives to adopting rules that fail to take account of the relevant market data and extant empirical analysis," said Gallagher. Continued the Commissioner, "as the Court of Appeals for the D.C. Circuit persists in reminding us…Either we build each of our rules on a solid empirical foundation and give the public a real opportunity to consider and comment on how it will affect them, or we run a serious risk of having our rules judicially nullified."

UPCOMING HEARINGS

On Tuesday, May 15th at 10am, in 215 Dirksen, the Senate Finance Committee will hold a hearing titled "Tax Reform: What It Could Mean for Tribes and Territories."

On Wednesday, May 16th at 10am, in 1100 Longworth, the House Ways and Means Subcommittee on Oversight will hold an oversight hearing on the operations of tax-exempt organizations.

On Wednesday, May 16th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold an oversight hearing on how the Financial Stability Oversight Council intends to exercise its discretionary authority to designate nonbank financial firms as SIFIs.

On Wednesday, May 16th at 1pm, in 2360 Rayburn, the House Small Business Committee will hold a hearing titled "U.S. Trade Strategy: What's next for Small Business Exporters?"

On Wednesday, May 16th at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on International Monetary Policy and Trade will hold a hearing on the access U.S. financial services firms have to the consumer market in China and what actions the U.S. can take to support firms seeking to do business in China.

On Wednesday, May 16th at 2pm, in 2220 Rayburn, the House Financial Services Subcommittee on Oversight and Investigations will hold a hearing titled "Oversight of the Federal Deposit Insurance Corporation's Structured Transaction Program."

On Wednesday, May 16th at 2pm, in G-50 Dirksen, the Joint Economic Committee will hold a hearing titled "How the Taxation of Labor and Transfer Payments Affect Growth and Employment."

On Thursday, May 17th at 10am, in 215 Dirksen, the Senate Finance Committee will hold an oversight hearing titled "The Social Security Administration: Is it Meeting its Responsibilities to Save Taxpayer Dollars and Serve the Public?"

On Thursday, May 17th at 10am, in 1100 Longworth, the House Ways and Means Committee will hold a hearing titled "Supporting Economic Growth and Job Creation through Customs Trade Modernization, Facilitation and Enforcement."

On Thursday, May 17th at 10am, in 2128 Rayburn, the House Financial Services Committee will hold a hearing on the policies of federal financial regulatory agencies when settling claims against defendants that neither admit nor deny wrongdoing in connection with the settlement.

On Thursday, May 17th at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity will hold a hearing on issues affecting the ability of U.S. insurance and reinsurance companies to compete internationally.

On Thursday, May 17th at 2pm, in 1100 Longworth, the House Ways and Means Subcommittee on Human Resources will hold a hearing on spending by the states on the Temporary Assistance for Needy Families (TANF) program, focusing on how much of the spending is directed to programs that fulfill TANF work requirements and on how that spending is calculated.

On Friday, May 18th at 9:30am, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on the Collins amendment to the Dodd-Frank Act.