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FINANCIAL SERVICES LEGISLATIVE AND REGULATORY UPDATE

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Leading the Past Week

The news last week was clearly dominated by JP Morgan's trading loss. However, while we anticipate that the bank will be in the forefront of the news for a few more weeks, it seems that any substantive impacts from the event will come from the Administration and not from Congress. Even though the Senate Banking Committee announced a hearing schedule where Jamie Dimon will be forced to testify, and that the political environment is so toxic that the House Agriculture Committee called off a hearing that would have modified Dodd-Frank regulations on swaps, it is unlikely that there will be any real legislative based changes to Dodd-Frank in response to JP Morgan's trading loss, as even in the midst of the news cycle, House Financial Services Committee Chairman Spencer Bachus (R-AL) noted that the \$2 billion loss represents approximately 1 percent of its total net worth of the bank and only "one month" worth of earnings—signaling the company will not be affected in the long-run. Conversely, the Administration appears to have much greater leverage against the bank, and politically the White House, despite the President's initial kind words about Jamie Dimon, have to be calculating the political value of coming down hard on the bank. With that in mind, it was not surprising to see that the Justice Department and the SEC have separately launched investigations into the bank's trades, and that Treasury Secretary Tim Geithner suggested JP Morgan CEO Jamie Dimon step down from the New York Fed. Of course, the greatest potential area for an impact will be in the implementation of the Volcker rule, and whether the news of JP Morgan's loss will impact how regulators choose to allow impacted entities the ability to hedge their assets. Many supporters of an aggressive implementation of the rule view JP Morgan's loss as a clarion call for a robust implementation - if not to go back to Glass-Steagall altogether, and so it was not surprising to see Senators Carl Levin (D-MI) and Jeff Merkley (D-OR) criticize regulators for creating a "JP Morgan" loophole in the proposed Volcker Rule and urging them to tighten the draft language. While it was clear that the news of the loss took the wind out of the sails of efforts to push back

against an aggressive implementation of Volcker, the question remains whether the wake from the loss will sweep up others in the industry.

Legislative Branch

Senate

Senators Call for Finalized Swaps Definitions

Last week, a bipartisan group of Senators wrote to the CFTC and SEC, urging them to move faster in implementing the final definitions for swaps and related items. The letter, signed by Senators Maria Cantwell (D-WA), Dianne Feinstein (D-CA), Tom Harkin (D-IA), Carl Levin (D-MI), all who have historically taken an aggressive position in trying to regulate “speculators” in the commodity markets, were joined by Olympia Snowe (R-ME), in stressing that the regulators need to move quickly to finally get around to defining these key terms so that other pending rules, such as the CFTC’s pending rule against excessive speculation, can be finalized. The CFTC adopted a final rule to establish position limits in October 2011; however, it cannot implement the rule until final definitions for swaps and swap-related entities are finalized. Position limits are not the only Dodd-Frank rulemaking languishing due to an unfinished swaps definitions; the SEC and CFTC have been adopting or announcing their intention to finalize many of the rules that would implement the swaps provisions of the Dodd-Frank Act, but note that the full impact of the rule will not be determinable until the CFTC and SEC are able to put out a final rule defining what activities will actually constitute a “swap.”

Senate Passes Ex-Im Reauthorization

On May 15th, by a bipartisan vote of 78 to 20, the Senate approved [H.R. 2072](#), the Securing American Jobs Through Exports Act, which extended the authorization and lending authority of the Export-Import Bank for another three years. The bill was approved by the House last week in a vote of 330 to 93 and the President is expected to sign the measure shortly.

Cybersecurity Efforts Continue to Stall in Senate

Once again it seems that the Senate has stalled on moving forward a cyber security bill, as a much anticipated meeting lead by Senators Sheldon Whitehouse (D-RI), Roy Blunt (R-MO), Barbara Mikulski (D-MD), and Jon Kyl (R-AZ) was abruptly rescheduled on Tuesday. There are currently two competing bills vying for the Senate’s attention. One measure, the Cybersecurity Act of 2012 ([S. 2105](#)), sponsored by Senators Joseph Lieberman (I-CT) and Susan Collins (R-ME), is broad legislation with provisions that would grant the Department of Homeland Security new authority to develop cybersecurity requirements for the nation’s “critical infrastructure” operators, including financial institutions. The measure is cosponsored by Commerce Committee Chairman Jay Rockefeller (D-WV) and Intelligence Committee Chairwoman Dianne Feinstein (D-CA). It is opposed by the U.S. Chamber and other industry groups. As an alternative, Senator John McCain (R-AZ), Ranking Member of the Armed Services Committee, along with the top Republicans on the Commerce, Justice and Intelligence Committees have introduced the SECURE IT Act ([S. 2151](#)), which primarily focuses on non-regulatory solutions, such as updating the U.S. criminal code and requiring the government to suggest, but not mandate, best practices for the operators of our nation’s critical infrastructure to consider when securing their systems.

Senate Approves Nominees to Federal Reserve Board

On May 17th, the Senate confirmed President Obama's two nominees to serve on the Federal Reserve Board of Governors. Harvard economics professor, Jeremy Stein was approved in a 70 to 24 vote and Jerome Powell, a former investment banker, was approved in a 74 to 21 vote. The approval of the two nominees marks the first time all seven members of the Federal Reserve Board have been filled since April 2006.

Rubio Introduces Resolution Disapproving of IRS Rules on Reporting Interest Paid to Nonresident Aliens

On May 14th the IRS and Treasury released joint [guidance](#) on final regulations proposed April 17th requiring financial institutions to report to the IRS any payments of interest paid to nonresident alien individuals on deposits held on U.S. offices of certain financial institutions. Following the guidance, Senator Marco Rubio (R-FL) introduced [S.J.Res. 40](#), a joint resolution disapproving of the rules. The resolution currently has 8 cosponsors, 7 Republicans and one Democrat.

Facebook has bumpy IPO as Levin Calls for closure of Stock-Option Tax Loophole

Even as Facebook began its first day as a public company on May 18th with trading issues that left NASDAQ "embarrassed," and the underwriting banks needing to prop up the share price so that it closed with a twenty-three cent increase over its opening value, Senator Carl Levin (D-MI) attacked the social networking company for its plans to take a tax deduction of up to \$16 billion. "Facebook should be paying its fair share," said Levin, "and it's only through a tax loophole that it won't be." Levin made his remarks on the Senate floor, calling for his colleagues to pass his bill to close the "stock-option loophole," the Ending Excessive Corporate Deductions for Stock Options Act ([S. 1375](#)).

House of Representatives

Boehner Expects Vote on 2001, 2003 Tax Cuts with a Bill to Hasten Tax Reform

On May 15th, House Speaker John Boehner (R-OH) told participants at the Peterson Foundation fiscal summit that the House will vote on a package to extend the 2001 and 2003 tax cuts and overhaul the tax code before the November elections. Boehner stressed that the economic recovery cannot sustain a tax increase and the bill to extend the tax cuts will also "establish an expedited process by which Congress would enact real tax reform in 2013."

In wake of JP Morgan House Republicans Ease Assault on Dodd-Frank

As mentioned earlier, the fallout from the JP Morgan trading loss claimed its first legislative victim this week as the House Agriculture Committee announced it would postpone a markup of several financial regulatory reform bills that was scheduled for May 17th. The Committee would have considered three bills which have already cleared the House Financial Services Committee: [H.R. 4235](#), the Swap Data Repository and Clearinghouse Indemnification Act; [H.R. 1838](#), the Swaps Bailout Prevention Act; and [H.R. 3283](#), the Swaps Jurisdiction Certainty Act. While Chairman Frank Lucas (R-OK) indicated that the subject of the markup was unrelated to JP Morgan's losses, even though the trade that was at the root of JP Morgan's trouble was a credit default swap, he said that the mark-up was rescheduled so as to avoid any "unintended

consequences.” Liberal groups applauded the postponement; Bartlett Naylor, financial policy advocate with Public Citizen’s Congress Watch, called the bills ill-conceived pieces of legislation and advised the Committee not to act at all.

House Financial Services Examines Progress of SIFI Designations Amidst Industry Concerns

At a hearing to examine what it means to be a systemically important financial institution (SIFI) on May 16th, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit heard from regulators charged with identifying and regulating large nonbank companies as well as potentially impacted members of the industry. The Financial Stability Oversight Council (FSOC) published a [final rule](#) on April 3rd which identifies a three-stage screening process to identify nonbank SIFIs whose failure would impact the broader economy. Testifying at the hearing, Lance Auer, Assistant Treasury Secretary for Financial Institutions, said the screening process will evaluate risk and characteristics of individual nonbank financial companies with factors such as size, interconnectedness, leverage, liquidity risk, and existing regulatory scrutiny. Firms under scrutiny will be contacted by FSOC with the opportunity to submit materials to the Council during the designation process. Auer added that the Council hopes to begin SIFI designations “sometime this year.”

Also testifying before the Subcommittee was Michael Gibson, Director of the Federal Reserve Board’s Division of Banking Supervision and Regulation, who echoed Mr. Auer’s comments, focusing on the individualized and tailored design of the designation process. Gibson told lawmakers nonbank supervision requires “a thoughtful and iterative analysis of each designated company over time.” Despite the regulators’ assurances, Subcommittee Chairman Shelley Moore Capito (R-WV) expressed concerns with how the “standards will work with the various business models of nonbank firms” and was skeptical that the Fed has the ability to regulate nonbank entities. Members of the nonbank insurance industry also appeared before the Subcommittee, expressing fears that insurance companies classified as SIFIs would be placed at a competitive disadvantage with increased capital requirements and higher liquidity levels. Bill Wheeler, President of the Americas Division of Metlife—one of four financial firms that recently failed Fed stress tests—told lawmakers that the Fed’s methodologies for assessing capital levels are not appropriate for its nonbank model.

House Financial Services Critiques SEC Settlement Policies

On May 17th, at a House Financial Services Committee hearing on financial regulators’ settlement practices, Democratic lawmakers expressed concern over the SEC’s practice of settling enforcement actions without requiring defendants to admit or deny allegations, warning that the policy makes settlements “just another cost of doing business.” The hearing was precipitated in part by the recent rejection of the SEC’s \$285 million settlement with Citigroup, where the Judge in the case charged both sides for not presenting enough facts to sustain a judgment. While many lawmakers expressed concern at the SEC’s practice, they stopped short of seeking a Congressional fix. SEC Enforcement Director Robert Khuzami defended the Citigroup settlement, saying it is unclear what an admission would have added to the settlement and warning that, if the ‘neither admit nor deny’ policy were changed there would be fewer settlements, greater delay in resolutions and prolonged time until investors receive relief.

House Financial Services Subcommittee Examines FDIC Structured Transaction Program

On May 16th, the House Financial Services Subcommittee on Oversight and Investigations held a hearing to conduct oversight on the FDIC's Structured Transaction Program. Witnesses included representatives from the FDIC, Bret Edwards, Director of the Division of Resolutions and Receiverships and Jon Rymer, Inspector General, and industry representatives: Stuart Miller, CEO of Lennar Corporation, Scott Leventhal, President of Trivoli Properties, and Ed Fogg, Owner of Fogg Construction. The focus of the FDIC testimony was how structured transactions are used as a strategy to maximize the value of assets secured by real estate for the benefit of the Deposit Insurance Fund (DIF) and the depositors and other creditors of the failed institutions.

House Passes Short-Term Extension of NFIP; Senate Struggling to Find Long-Term Compromise

On May 17th, the House voted to extend the National Flood Insurance Program (NFIP). The bill (H.R. 5740), which passed the House by 402 to 18, is a stopgap measure that would extend the program's funding through June 30th, giving the Senate an additional six weeks to finalize a long-term reauthorization to send to the House. Earlier last week, Senate Majority Leader Harry Reid (D-NV) attempted to bring to the floor S. 2344 which would extend the NFIP through December 31, 2012; however, Senator Tom Coburn (R-OK) objected and threatened to block all flood insurance reauthorization bills that do not contain a major overhaul of the program. The House's short-term extension would direct FEMA and the GAO to conduct studies on strategies for privatizing flood insurance and make recommendations to Congress on implementation of such a plan.

Executive Branch

Treasury

Treasury to Push for More Access to Chinese Markets for U.S. Banks

One week after the Federal Reserve allowed Chinese banks to expand their reach into the U.S., Treasury Secretary for International Affairs Lael Brainard said the United States will press China to allow the U.S. banking sector more access to its markets. The comments came during a House Financial Services International Monetary Policy and Trade Subcommittee hearing on increasing market access to China. The hearing came on the heels of Chinese authorities raising the cap—set by its World Trade Organization (WTO) commitments—on foreign investment in Chinese securities firms to 49 percent from the previous ceiling of 33 percent. Republican Representative Donald Manzullo (R-IL), was not impressed with China's gesture, noting that “we don't have anything mutual going on here,” and chiding the Administration for not taking the “opportunity” to push for U.S. companies to have more access to foreign direct investment in China.

Regulators Publish Guidance on Key Stress Test Principles

On May 14th, regulators unveiled final guidelines on internal stress tests designed to prepare banks to meet the challenges associated with stressful events and prevent such threats from undermining banks' financial conditions. The Federal Reserve, the FDIC, and the OCC jointly released [guidance](#) on stress tests for banks with more than \$10 billion in assets. The guidance is

based on proposed regulations released for comment in June 2011. Commenters on the proposed rules had expressed concerns around the application of the proposed guidance to savings and loan holding companies (SLHCs), advising that the Fed issue separate guidance for SLHCs. The final rule reflected the agencies' belief that the guidance contains flexibility adequate to accommodate the variations in size, complexity, business activities, and risk profiles of all banking organizations meeting the asset threshold.

While the guidance does not implement the stress testing requirements mandated by the Dodd-Frank Act or in the Fed's capital plan rule—these will be implemented through separate agency proposals—the final guidance contains general key principles that banks may use to structure their stress tests:

- Stress testing framework should include activities and exercises that are tailored to and sufficiently capture the banking organization's exposures, activities, and risks;
- An effective stress testing framework employs multiple conceptually sound stress testing activities and approaches;
- An effective stress testing framework is forward-looking and flexible;
- Stress test results should be clear, actionable, well supported, and inform decision-making; and
- An organization's stress testing framework should include strong governance and effective internal controls.

OCC

OCC Head Warns Against Growing Operational Risks in Banking

On May 16th, speaking before the Exchequer Club, U.S. Comptroller of the Currency Thomas Curry, said operation risk for banks is high and increasing, with some supervisors seeing it as surpassing credit risk as a safety concern. Coming just a week after the \$2 billion loss at JP Morgan, Curry's [prepared remarks](#) on operational risk did not mention the company by name. However, Curry did say: "Given the complexity of today's banking markets and the sophistication of technology that underpins it, it is no surprise that the OCC deems operational risk to be high and increasing." Lawmakers have also alluded to the JP Morgan loss as further argument for the controversial Volcker Rule proprietary trading ban to be implemented.

CFTC

CFTC Contemplating Changes to Ease Trading Positions Regulation

Last week, Bloomberg reported that the CFTC is considering proposals to ease Dodd-Frank Act regulations limiting speculation in oil, natural gas, wheat and other commodities. This may include a proposal to raise the threshold of when a company is considered to have an ownership stake and thus must add trading positions from 10 percent to 50 percent. The possible changes were immediately attacked: "This change goes in the wrong direction," said Marcus Stanley, Policy Director for Americans for Financial Reform, citing additional weaknesses with the rule. The change would affect the position limit rules completed by the CFTC in October 2011. The limits would cap the number of contracts a trader may have and is currently the subject of a

lawsuit by the International Swaps and Derivatives Association (ISDA). However, these rules may yet be revised, in response to lobbying from large agriculture and energy firms.

SEC

Schapiro Talks Money Markets to Investment Company Institute

On May 11th, in remarks before an Investment Company Institute conference, SEC Chairman Mary Schapiro clarified that it is not government's role to set the size, or reign in, the money market mutual fund industry. "They should be the size they should be," said Schapiro, continuing, "I want them to be resilient. I want them to be reflective of the fact that they are investment products and their value does indeed fluctuate." Still, the MMF industry peaked at \$3.9 trillion in 2009, since declining to approximately \$2.6 trillion. Industry groups have expressed fears that regulators, specifically the Federal Reserve, are pressuring the SEC to reign in money market funds.

Currently, the SEC is considering two proposals addressing money markets. The first proposal would move funds away from the historic fixed net asset value (NAV) of \$1 to a floating NAV. The second option would be to create capital requirements and restrictions on redemptions. Thus far, Schapiro does not have enough votes on the Commission to release a proposal for public comment—both Republican Commissioners, Troy Paredes and Daniel Gallagher, are opposed to additional regulations and Democrat Luis Aguilar is undecided. Also on May 11th, Paredes, Gallagher and Aguilar released a [statement](#) opposing an International Organization of Securities Commissions [document](#) which found "confidence shocks" in money market funds can "quickly have a broader macroeconomic effect."

Industry Group Reminds Investors Crowdfunding Not Yet Legal

On May 15th, the North American Securities Administrators Association (NASAA) [alerted](#) investors that crowdfunding will remain unlawful. The alert notes that although the President has signed the JOBS Act, which allows crowdfunding, it is not actually legal to crowdfund until the SEC issues regulations—which it has 270 days from enactment to do. NASAA cautioned investors to also be wary of the high "potential for fraud" when the crowdfunding exemption does begin, given limited disclosures to investors and less regulation than securities.

FHFA

FHFA Outlines Future of GSEs in Strategic Five Year Plan

On May 15th, the FHFA released a five-year draft [Strategic Plan: Fiscal Years 2013-2017](#) that lays out new conservatorship goals and mortgage market features that could replace the GSEs Fannie Mae and Freddie Mac. The plan incorporates four major goals for the FHFA over the next five years: ensuring the safety and soundness of the GSEs; maintaining stability, liquidity, and access to housing finance; conserving the firms' assets; and preparing for the future of housing finance. As part of preparing for the future of housing finance, the Strategic Plan lays out principles for the return of private capital to mortgage securitization markets such as continuing to raise guarantee fees to bring the cost of GSE mortgages in line with that of private loans. The plan also states that FHFA may develop new types of loss-share arrangements to allow investors to take on more risk and lessen the burden of risk taken on by Fannie and

Freddie. While housing reform is not expected to move forward in Congress until after the 2012 elections, the FHFA believes the Strategic Plan could help prepare for eventual Congressional reforms.

UPCOMING HEARINGS

The House of Representatives is in Recess this Week

On Tuesday, May 22nd at 10am, in 538 Dirksen, the Senate Banking, Housing, and Urban Affairs Committee will hold a hearing titled “Implementing Derivatives Reform: Reducing Systemic Risk and Improving Market Oversight.”

On Wednesday, May 23rd at 2pm, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Subcommittee on Security and International Trade and Finance will hold a hearing titled “Reviewing the U.S.-China Strategic and Economic Dialogue.”

On Thursday, May 24th at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing on the Responsible Homeowner Refinancing Act of 2012