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FINANCIAL SERVICES REGULATORY REFORM UPDATE

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During this past week, the President and Republican leaders in the Senate appeared to agree to a tax-cut package, although it remains unclear whether there will be the requisite Democratic support for the proposal. Despite the fact that the cost of the proposal exceeds the stimulus package enacted by Obama early in his first term (as it currently stands, the entire package will cost \$858 billion, \$801 billion of which would go to tax breaks), there seems to be little support amongst Democrats, and particularly liberal Democrats for the compromise package. In fact, House Democrats, lead by Peter Welch (D-Vt) and Peter DeFazio (D-OR) pushed a resolution in the Democratic caucus urging the Speaker not to take up the measure. Interestingly, the proposal passed on a voice vote, so that members did not have to publicly disclose their position. House Speaker Nancy Pelosi (D-CA) has stated that she will continue discussions with the President and other legislators in order to “improve the proposal” before it moves to the House for a vote. Congressman Levin (Chairman of the House Ways and Means Committee) has also indicated that he will tinker with the deal before it comes to the floor and we anticipate that at the very least we anticipate that House Democrats will seek to eliminate what they view as one of the most controversial provisions in the Senate tax proposal, setting the estate tax exemption at \$5 million per person and a top rate of 35%, will be modified on the chopping block.

At this point, despite all of the rhetoric, it would seem more likely than not that legislation will pass before the end of the year, although there are some who believe that the Republicans would prefer that the tax cuts expire under a Democratic House and Senate, so as to be able to campaign on the issue in 2012.

HOUSE FINANCIAL SERVICES COMMITTEE: 112th CONGRESS OUTLOOK

As expected, Rep. Bachus was named Chair of the House Financial Services Committee, which has primary oversight of the SEC. Additionally, it was announced that the total number of full Committee members will drop from 72 to 59, and as a result Democrats will be losing 2-4 members, on top of their other losses. Also, Rep. Bachus announced the new GOP leadership for the Committee in the 112th Congress. The list is as follows:

- Rep. Jeb Hensarling (R-TX), Vice Chairman, full Committee
- Rep. Judy Biggert (R-IL), Chairman, Insurance, Housing and Community Opportunity
- Rep. Shelley Moore Capito (R-WV), Chairman, Financial Institutions Subcommittee
- Rep. Scott Garrett (R-NJ), Chairman, Capital Markets and Government-Sponsored Enterprises Subcommittee
- Rep. Ron Paul (R-TX), Chairman, Domestic Monetary Policy Subcommittee
- Rep. Gary Miller (R-CA), Chairman, International Monetary Policy Subcommittee

Rep. Randy Neugebauer (R-TX), Chairman, Oversight and Investigations Subcommittee

The GOP will also be adding the following members to the Committee (in alphabetical order, as seniority has not yet been determined): Reps. Quico Canseco (R-TX), Bob Dold (R-IL), Sean Duffy (R-WI), Michael Fitzpatrick (R-PA), Michael Grimm (R-NY), Nan Hayworth (R-NY), Bill Huizenga (R-MI), Robert Hurt (R-VA), Blaine Luetkemeyer (R-MO), Stevan Pearce (R-NM), Steve Stivers (R-OH), and Lynn Westmoreland (R-GA)

Since 15 Democratic members of the House Financial Services Democrats either retired or lost their seats in the mid-term elections, we anticipate that 2-4 additional Democrats will need to be removed from the Committee in order to maintain the appropriate Democrat-to-Republican ratio. Based on seniority that would mean that the four least senior members risk losing their positions: Reps. Gary Peters (D-MI), Jim Himes (D-CT), Jackie Speier (D-CA) and André Carson (D-IN), although it will be interesting to see if Barney Frank pushes to keep Peters and Himes, as both have distinguished themselves on the committee, with Peters serving on the Dodd-Frank conference committee..

Bachus has already stated that housing finance reform is at the top of his to-do list, and “to end the taxpayer funded bailout of Fannie and Freddie.” During the current term, House Republicans introduced legislation (the GSE Bailout Elimination and Taxpayer Protection Act, H.R. 4889) that would gradually phase out Fannie and Freddie, which we expect might see some movement in the 112th Congress with Bachus’ support. In a related matter, the issue of government guarantees in the secondary mortgage market is also expected to be a contentious matter in the next year, and we heard that Rep. Garrett will be playing a significant role in this policy discussion. Bachus also plans to go “title by title” through Dodd-Frank in order to “correct, replace, or repeal the job killing provisions that unnecessarily punish small business and community banks that did nothing to cause the financial crisis.”

On a related note, Rep. Frank Lucas (R-OK) was voted in as the new chairman of the House Agriculture Committee, which has jurisdiction over the CFTC. Previously, Lucas was the Ranking Member on the Committee, and had opposed the then-Chairman Peterson’s derivatives provisions in Dodd-Frank (in addition to voting against the entire bill). Lucas has pledged that his Committee will be playing a strong oversight role, in order to fulfill its “duty to the American people.”

SEC AND CFTC PROPOSE RULE DEFINING SWAP TERMS

Last week, the SEC unanimously voted to propose joint rules with the CFTC to define “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant,” and “eligible contract participant,” in keeping with their Dodd-Frank mandate to establish a comprehensive framework for regulating the OTC swaps market. SEC Chair Mary Schapiro noted that this is “just a first step” and the agency will be accepting public comment for 60 days (through February 1st) in order to help the agencies “appropriately address the market impacts and potential risks posed by these entities.” More information on the proposed definitions is available [here](#).

FED TO DISCUSS INTERCHANGE RULES

Under Dodd-Frank, the Federal Reserve has 9 months from the legislation’s July enactment to pass a set of rules for debit card interchange fees. As that deadline approaches, the Fed announced that it will be meeting next Thursday, December 16th at 2:30pm, to discuss proposed rules in this area. The Fed is

charged with ensuring “reasonable fees,” broader network access, and other related rulemaking associated with electronic debit transactions. The Dodd-Frank provision, Section 1075, written by Sen. Dick Durbin (D-IL), has already evoked a slew of questions on about the financial sector’s profit prospects in the future, and the potential for lawsuits once the rules are enacted.

Along these lines, a group of 12 Senators – both Democrats and Republicans – sent a letter to Fed Chair Ben Bernanke, stating their concern for the dramatic changes that could ensue from a new interchange rule, and a “government-controlled system.” The Senators requested that the Fed take its time to consider the broad implications of this rule, and the potential consequences on “consumers as well as institutions under \$10 billion.”

WITNESSES URGE INCREASE IN SMALL OFFERING EXEMPTION

On December 8, Rep. Eshoo urged the House Financial Services Committee to direct the SEC to increase the exemption for small offerings from \$5 million to \$30 million. Eshoo testified that increasing the exemption would lead to job creation, facilitate development of new technology and products and revitalize the Securities Act.

Under Regulation A of the Securities Act, public offerings under \$5 million are exempt from registration. Companies that rely on this exemption file offering statements that consist of a notification. Although the SEC has the authority to change the threshold without Congressional action, Eshoo said Congressional oversight is very important.

Chairman Barney Frank said raising the threshold would be uncontroversial and the SEC could likely address the issue in 2011. Frank hoped that the SEC and the CFTC would be able to get significant budget increases for FY 2011 to help with their new responsibilities under the Dodd-Frank Act.

SEC CONSIDERS RULES TO REDUCE VOLATILITY AND “EXTREME” ALGORITHM TRADING

The SEC is looking into adding a “limit up, limit down” component to existing circuit breaker rules that were created in response to the May 6th stock market flash crash. The new provision would allow stocks experiencing price volatility to continue trading, but once the stock price fluctuated too extremely, trading would be halted. This is a more nuanced approach to the current rules, which would halt trading for a security if it experience a 10 % price change during a 5-minute period. The SEC is still considering what constitutes “too extreme” trading, which would trigger a cessation in trading.

The agency is also considering a rule that would prevent “extreme” trades from being placed by imposing restrictions on algorithm trading programs, and possibly imposing oversight on individuals who create these programs as well. SEC Trading and Markets Associate Director David A. Shillman stated that any rulemaking would aim only to prevent “a very extreme” price move, and that the SEC is not looking to heavily regulate these algorithms. The SEC and the Financial Industry Regulatory Authority recently contacted market participants to gather information because of concerns over the use of algorithms. FINRA CEO also stated that algorithms cannot continue to operation “without evaluating their results, their impact, and without clearly understanding how they work in periods of excessive and extraordinary volatility.”

SEC WEIGHING UPDATING THE CUSTODY RULE FOR BROKER-DEALERS

Speaking at the annual conference for the American Institute of Certified Public Accountants on Monday, SEC Chair Mary Schapiro stated that her agency is looking into ways to help investors “shake their skittishness.” Specifically, she called upon the accounting profession to engage in a public-private effort help restore “the public’s trust in America’s capital markets.” The SEC is looking into updating the custody rule for broker-dealers, which would require “auditors to provide assurance that their numbers are accurate, as well as controls and compliance.” The agency is also considering the following:

1. Weighing an enhancement of oversight of broker-dealer custody “by providing new information and tools to regulatory examiners”;
2. Considering strengthening compliance and controls over the SEC's “foundational financial responsibility and customer protection requirements”;
3. Preparing “a 21st century foundation” on which the Public Company Accounting Oversight Board can implement its new oversight authority over broker-dealer audits; and
4. Weighing elimination of regulatory overlap for broker-dealers who also act as related custodians of a registered investment adviser.

MSRB SEEKING COMMENTS ON PAY-TO-PLAY RULES FOR MUNICIPAL ADVISORS

Michael Bartolatta, the chairman of the Municipal Securities Rulemaking Board board of directors, stated on Monday that his organization is looking into restricting political contributions made by municipal advisors to government officials responsible for awarding advisory work. MSRB will issue a request for comment in the near future, and also expects to issue guidance for comment early next year on a fiduciary duty for municipal advisers. At the MSRB’s special meeting last week, the board made “considerable progress in reaching an agreement” on a potential fiduciary duty rule and interpretive guidance.

BUILD AMERICA BONDS EXCLUDED FROM TAX PACKAGE

Notably missing from the Republicans compromise with President Obama is a provision to include the Build America Bonds (BABs) program. The current subsidies (35% rebate of interests costs) will expire on December 31st, and in the meantime they account for more than 20% of new debt sold by states and local governments. GOP staffers have made it abundantly clear that Republicans “are not going to allow them to be included” in any tax deal that is approved by Congress. One financial services lobbyist theorized that this is a coordinated campaign motivated by one or more hedge funds that set up big bets against municipal indexes or specific states’ bonds, and then lobbied to ensure that BABs aren’t extended. The DC insider called it “lobbying for tradable outcomes.”

SIFMA COMMENTS TO FINRA ON ARBITRATION PROCEEDINGS

Last week, the Securities Industry and Financial Markets Association (“SIFMA”) sent a comment letter to the Financial Industry Regulatory Authority (“FINRA”), stating its support for the expansion of a public arbitration process. Specifically, SIFMA would like to see an extension of FINRA’s pilot program allowing investors in arbitration proceedings with broker-dealer firms to elect for a panel of public

arbitrators. SIFMA does not, however, support a proposal that would expand the program to customer disputes with individually named brokers. The comment letter came on the heels of a FINRA announcement to seek SEC approval for a rule change that would give all investors pursuing arbitration the right to exclude industry representatives from panels hearing their disputes with a brokerage firm. The rule is intended to boost the “perception of fairness” in FINRA arbitration hearings.

CFTC MAKES SOME HEADWAY IN DODD-FRANK MANDATES

Yesterday, the CFTC proposed three rules and adopted one interim final rule. One rule would exempt trades by commercial businesses from a requirement that a clearinghouse guarantee the transaction and impose margin requirements. Another rule would minimize conflicts of interest through reporting and transparency requirements for derivatives clearing organizations, designated contract markets, and swap execution facilities. The final rule would create business conduct standards for swap dealers and major swap participants, to protect their counterparties. The interim final rule defines “transition swaps,” and is intended to “advise potential counterparties that reporting requirements applicable to transition swaps will be adopted,” which signifies that there will also be an obligation to preserve certain data pending implementation of these rules.

The CFTC delayed consideration of a proposal that would force most swaps to be traded on exchanges. Chairman Gary Gensler said the agency would reconsider the proposal in the next week. The Dodd-Frank Act requires that swaps be traded on exchanges but left the CFTC to design the system. The proposal would set rules for swaps that are traded at least 10 times a day to go through new “swap execution facilities” designed to increase transparency in the over-the-counter market. Block trades, low-volume trades, or trades not required to go through a third-party clearinghouse would be exempted in favor of a ‘request for quote’ model.

SEC: CONSOLIDATED AUDIT TRAIL NEEDED TO PREVENT ANOTHER FLASH CRASH

At a joint hearing of the Senate Permanent Subcommittee on Investigations and the Senate Banking Committee earlier this week, SEC Chairman Schapiro said that the SEC needs more time and money to establish a consolidated audit trail for detecting stock exchange manipulation. When the idea was originally proposed the SEC thought broker-dealers would have to acquire costly surveillance technology to feed data into a consolidated audit trail system; however, the SEC has learned that current technology will suffice.

A consolidated audit trail would establish a central repository of data to allow the SEC and other regulators to monitor trading activity. The hope is that the trail will enable regulators to timely and effectively access data and avoid another situation akin the May 6 flash crash. While Schapiro did not address the perceived delay between May 6 and publication of the regulatory report, CFTC Chairman Gary Gensler said that his staff had to analyze millions of orders in order to reach any conclusions.

CFTC COMMISSIONER URGES PASSAGE OF POSITION LIMITS FOR FUTURES

Speaking at a High Frequency Trading World conference on Wednesday, CFTC Commissioner Bart Chilton stated that speculative money is being invested in the commodity futures market “at a blistering pace,” and urged his agency to pass a position limit law for energy and metals contracts by next month. Chilton stated that there is now \$149 billion in speculative money in commodities markets, which is an

unprecedented number of futures contracts. Chilton acknowledged that speculation is needed for liquidity purposes, but explained that the “sheer size” of all those contracts has “the potential of moving markets, of influencing true price discovery.” Congress mandated that the CFTC institute a mid-January implementation date for energy and metals position limits, but Chilton noted that there are creative ways to get around this, but approving a final rule with a far off effective date.

UPCOMING HEARINGS

On Wednesday, December 15th at 10am, in 2141 Rayburn, the House Judiciary Committee will hold a hearing entitled “Foreclosed Justice: Causes and Effects of the Foreclosure Crisis.”