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FINANCIAL SERVICES REGULATORY REFORM UPDATE

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With the House of Representatives in recess this past week, and a relatively quiet week in the Senate, the biggest stories were a couple of sensational items -- most prominently – and splashed across front pages worldwide - the arrest of Dominique Strauss-Kahn, the (now) former head of the International Monetary Fund (IMF), for his alleged sexual assault of a hotel maid in New York City. Strauss-Kahn resigned on Thursday, and his resignation created a pitched battle behind the scenes about who will be his successor. Traditionally, European (and, more often than not, French) leaders have taken on this post, but there has been a strong push from some developing countries (including China) to select an Asian director. Notwithstanding the delightful irony of a communist country running the IMF, we anticipate that a European, with the odds on favorite being, French Finance Minister Christine Lagarde, will remain at the helm of the IMF when it's all said and done.

Also in rather dramatic fashion, this past week witnessed the possible dissolution of the Gang of Six, when its most conservative member – Sen. Tom Coburn (R-OK) – removed himself (at least temporarily) from the group on Thursday morning. The Gang of Six, made up of three Democratic and three Republic senators, had been seen as one of the most promising efforts to find a compromise on the federal budget, though its failure to produce a plan was starting to raise concerns about its relevance. According to reports, the genesis of Coburn's departure was related to a heated argument with Sen. Dick Durbin (D-IL) on Wednesday evening over Coburn's demands to cut domestic spending, including $130 billion more out of Medicare. Unquestionably, the two senators have diametrically opposed political views, but also may be the two with the most clout in the Gang of Six, since any decisions they agree to would likely bring many in their respective bases along. With Coburn absent from the group, it is difficult to imagine compromise being reached by an increasingly polarized Congress, though there is an effort underway to "sub" in Senator Rob Portman, who while respected, does not have the same gravitas amongst conservatives as Coburn. Of course, the Biden lead group continues to plug along, and as we've indicated previously, should serve as a fall back for an agreement on "mutually agreeable" items, but is unlikely to produce the more substantive fix that the Gang of Six was working on.

Interestingly, though perhaps coincidently, as the Gang of Six talks were breaking down, there was an increase in the rhetoric from the most conservative elements of the Republican party that the August 2nd default date is nothing more than a fiction, conceived by the White House to frighten people into raising the debt limit. With the likelihood of a grand compromise on deficit and debt ceiling potentially fading, it sounds like the alternative that is gaining traction will be to enact a small series of increases in the debt ceiling, each tied to corresponding cuts in the budget.

SENATE BANKING SUBCOMMITTEE EXAMINES SECURITIZATION INDUSTRY

On May 18th, representatives from the commercial real estate finance industry and academia testified before the Senate Banking Subcommittee on Securities, Insurance, and Investment on the state of the securitization markets one year after the Dodd-Frank Act was enacted. In his remarks, Chairman Jack Reed (D-RI) noted that although securitization of loans is useful in reducing borrowing costs, "the financial crisis revealed a troubling aspect to an increasingly Byzantine and opaque securitization process, which has had a devastating effect on our economy."

One of the primary concerns expressed by witnesses at the hearing was the effect of risk retention requirements on commercial mortgage-backed securities. Banking regulators jointly issued a proposed risk retention rule on March 31st that requires issuers of asset-backed securities to retain 5% of the risk in any transaction. Industry stakeholders have been vocal in their opposition to the proposed rule, arguing that it will result in a significant drop off in the number of commercial real estate loans that are securitized. Unlike their residential counterparts, there was not an analogous "QRM" for commercial loans. Multiple witnesses condemned the "premium capture cash reserve account" provisions of the rule that the executive director of the American Securitization Forum claimed would "ultimately make the securitization business a not-for-profit business, effectively shutting down large swaths of the RMBS and CMBS business."

The hearing comes the same week as increased scrutiny of the mortgage industry in New York, where state Attorney General Eric Schneiderman opened an investigation into the securitization of mortgage loans. The AG is holding meetings with executives of major banks—including Bank of America, Morgan Stanley and Goldman Sachs— and has requested documents related to securitization, questionable mortgage practices and robo-signing. There have also been subpoenas issued to investment firms who own stakes in paperwork processing firms.

HOUSE DEMS PUSH FOR RECESS APPOINTMENT OF WARREN AT CFPB

With the one year anniversary of the enactment of Dodd-Frank barely less than three months away, this past week saw a renewed push for a recess appointment of Elizabeth Warren as head of the new Consumer Financial Protection Bureau (CFPB). Warren, who has been serving as a special advisor to President Obama and Treasury Secretary Geithner, and acting as the *de facto* head of the CFPB, is considered unable to be confirmed through the Senate, and compounding matters is the fact that the Republican's continue to push for a five-person commission instead of a single director to head the bureau.

On Friday, Reps. Carolyn Maloney (D-NY), Keith Ellison (D-MN) and Brad Miller (D-NC) sent a Dear Colleague letter to their fellow representatives, urging them to sign on to a letter asking President Obama for a recess appointment of White House special advisor Elizabeth Warren as the first ever

director of the Consumer Financial Protection Bureau. The members' letter states unequivocally that a recess appointment would be necessary and desirable:

"Since you appointed Professor Warren to "stand up" the bureau, she has laid the foundation as a strong advocate for consumers—something that seems to strike fear among those who are opposed to reform... Since Republican Senators have said that no one is acceptable unless the law is weakened, we would urge you to nominate Professor Warren as the CFPB's first Director anyway. If Republicans in the Senate indeed refuse to consider her, we request that you use your constitutional authority to make her a recess appointment."

Many liberal groups support the appointment of Warren, who has been a strong advocate for consumers and is ostensibly credited with formulating the concept of a consumer protection agency in the first place. However, the idea of Warren leading the CFPB appears to be anathema to Republicans and Wall Street, both of whom have lobbied strongly against her appointment. Complicating matters further is the fact that Republican Senators are threatening that the decision to appoint Warren through the recess process would be tantamount to a "nuclear option" and in response the Senate would block many other vacancies for regulatory position critical to implementing Dodd-Frank. The immediate response by Democrats to these threats is that Obama's appointees are not getting confirmed now, so what does he have to loose. We anticipate the Warren appointment, along with other Dodd-Frank appointments to play out in the next three months before the end of the August recess.

CFPB ANNOUNCES PROGRAM TO STREAMLINE MORTGAGE DISCLOSURE FORMS

Meanwhile, acting without a confirmed director, the CFPB announced the "Know Before You Owe" initiative. The program began May 18th with testing prototypes of two versions of simplified mortgage costs disclosure forms. The new forms combine two federally mandated mortgage disclosure forms into one streamlined form which outlines costs and risks of loans and enables consumers to better compare different loans. The testing of the prototypes will involve interviews with consumers, lenders and brokers over the coming months and the collection of public comment on the CFPB website.

Under current law, those applying for mortgage loans receive two forms: the Truth in Lending Act (TILA) disclosure and the Real Estate Settlement Procedures Act (RESPA) Good Faith Estimate. These forms are designed to impart basic information about the home loan process but have been shown to carry redundant information and over complicated language. Congress has long urged regulators to streamline documents and directed the CFPB to do so in the Dodd-Frank Act. The Bureau is required to finalize proposed forms and implement regulation by July 2012 for comment.

While the proposal generally received strong marks from the industry, as the American Banker noted that Ron Haynie, President and CEO of ICBA Mortgage, and other industry leaders praised the effort as a "a good first step toward merging the disclosure forms required under the Truth in Lending Act and Real Estate Settlement Procedures Act". It had its detractors as well, as David Stevens, President of the Mortgage Bankers Association expressed skepticism about the proposal, noting that task of streamlining the forms will be difficult. He said in the past regulators have struggled with the "paradox" of trying to provide adequate information in simple terms.

CFTC COMMISSIONER, NEW YORK DELEGATION SKEPTICAL OF PROPOSED SWAP RULES

Recently, CFTC Commissioner Scott O'Malia criticized aspects of several CFTC Dodd-Frank rulemakings. O'Malia said the proposed definition of a swap dealer is overly broad and would capture commercial end-users and that the proposed rules for swaps trades are "contrary to the intent of Congress." This is not the first time the Republican commissioner has spoken on the need for revisions to draft swaps rules. At the Federal Reserve Bank of Chicago's annual conference last week, O'Malia voiced similar concerns, saying that the rules will affect end-users seeking to hedge risk.

The December CFTC proposed rule defines a swap dealer as any entity that makes a market for swaps, enters into swaps with counterparties "as an ordinary course of business," is a dealer of swaps or is "commonly known in the trade" as a market maker for swaps. The rule also includes a de minimis exemption for those that do not: engage in more than $100 million in aggregate swaps per year; engage in over $25 million in swaps with "special entities" per year; or act as a dealer with more than fifteen counterparties per year. O'Malia said instead of the exemptions, the rule should contain a de minimis "predominance test" to determine if an institution is a nonbank financial firm.

O'Malia is not the only public official concerned with the CFTC's proposed rules. In a letter to the heads of the FDIC, Fed, CFTC and OCC the New York Congressional Delegation expressed its concern over the proposed margin regulations for non-US subsidiaries of US firms. The letter expressed concern that the proposals will "inevitably result in significant competitive disadvantages for U.S. firms operating globally." The letter notes that Congress was mindful of the need for a balance between safeguards and maintaining US competitiveness and the proposed rule does not reflect this balance. The letter asked regulators to revisit the international application of margin requirements.

Republicans in the House immediately pounced on the letter, noting that signers including Carolyn Maloney, Gary Ackerman and Greg Meeks, all members of the House Financial Services Committee and that the Committee would be voting on a measure this coming week that would address the concerns raised in the letter by delaying these rulemakings to allow for further review and consideration. It will be interesting to see how these New York members vote on this legislation at the mark-up, which had been anticipated to be a fairly partisan event, now that they are on the record about this issue.

SENATORS INTRODUCE BILL TO LIMIT INVESTORS ABILITY TO USE RETIREMENT SAVINGS AS "RAINY DAY FUNDS"

On Wednesday, Senators Herb Kohl (D-WI) and Mike Enzi (R-WY) introduced S. 1020, the "Savings Enhancement by Alleviating Leakage in 401(k) Savings Act of 2011" (the SEAL Act), which is intended to prevent permanent leakage from Americans' retirement savings. The bill would do so by modifying loan repayment hardship tax rules and limiting 401(k) loan practices that provide easy access to retirement funds and add costs and fees to pension plans. Kohl's and Enzi's effort is based on the findings of a 2009 GAO report on the long-term effects of 401(k) loans and leakage on workers' retirement savings.

According to Kohl, "during these difficult economic times, we are increasingly seeing 401(k) funds being treated as rainy day funds… a 401(k) account should not be used as a piggy bank for revolving loans." His and Enzi's bill would reduce the number of loans individuals may take out of their 401(k) plans to a maximum of three (though employers would have the option of reducing this further), and give them more time to return the funds after losing a job. The bill would also ban debit cards linked to the accounts, and would allow individuals to contribute to the plan after taking a hardship withdrawal. According to an Aon Hewitt study also released on Wednesday, at the end of 2010 almost 28% of individuals with 401(k)-type accounts had outstanding loans, with an average outstanding loan balance of $7,860.

SEC UNANIMOUSLY PROPOSES RULES TO STRENGTHEN CREDIT RATINGS – WHISTLE BLOWER RULES UP NEXT

In implementing Sections 932, 936 and 938(a) of the Dodd-Frank Act, the SEC voted unanimously on Wednesday to propose a 517-page package of rules and amendments to the 1934 Securities Exchange Act related to the practices of nationally recognized statistical rating organizations (NRSROs). The proposal is intended to improve the transparency and integrity of credit ratings issued by NRSROs, which currently number ten in total. Specifically, the proposed rules would require NRSROs to submit annual reports on internal controls, augment training for credit analysts, consistently apply rating symbols, prevent conflicts of interest with regard to sales and marketing and provide standardized disclosures on the performance of credit ratings. The rules would also require a third party due diligence providers for asset-backed securities (ABS) to provide written certification to NRSROs that rate the ABS. In a speech about NRSRO regulation, SEC Chairman Mary Schapiro strongly encouraged stakeholders to comment on the proposed rules so as to assist the SEC in "formulating sound rules and regulations."

The Commission also announced that it would be voting on the revisions to its Whistleblower rules as mandated by Dodd-Frank at its next meeting, which will take place next week on the 25th of May. These rules, which could effectively incentivize corporate whistleblowers to bypass internal compliance mechanisms, should be of grave concern to any public company.

UPCOMING HEARINGS

On Tuesday, May 24th at 9am, in 2128 Rayburn, the House Financial Services Committee will mark up pending legislation, including H.R. 1573, a bill to facilitate implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, promote regulatory coordination, and avoid market disruption.

On Tuesday, May 24th at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing on public proposals for the future of the housing finance system, part II.

On Tuesday, May 24th at 1:30pm, in 2154 Rayburn, the House Oversight and Government Reform Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs will hold a hearing titled "Who's Watching the Watchmen? Oversight of the Consumer Financial Protection Bureau."

On Tuesday, May 24th at 2pm, in 2128 Rayburn, the House Financial Services International Monetary Policy and Trade Panel will hold a hearing titled "Legislative Proposals on Securing American Jobs Through Exports: Export-Import Bank Reauthorization."

On Tuesday, May 24th at 2pm, in 1100 Longworth, the House Ways and Means Committee will hold a hearing on how other countries have revised their international tax rules to enable countries headquartered in those nations to compete more effectively in the global marketplace.

On Wednesday, May 25th at 9:30am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance and Investment will hold a hearing titled "Derivatives Clearinghouses: Opportunities and Challenges."

On Wednesday, May 25th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity will hold a hearing titled "Legislative Proposals to Determine the Future Role of the Federal House Authority, Rural Housing Service and Government National Mortgage Association in the Single- and Multi-Family Mortgage Markets."

On Wednesday, May 25th at 10am, in 1300 Longworth, the House Agriculture Subcommittee on General Farm Commodities and Risk Management will hold a hearing titled "Harmonizing Global Derivatives Reform: Impact on U.S. Competitiveness and Market Stability."

On Wednesday, May 25th at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises will hold a hearing titled "Transparency, Transition and Taxpayer Protection: More Steps to End the GSE Bailout."

On Thursday, May 26th at 9:30am, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on oversight of the Federal Deposit Insurance Corporation.

On Wednesday, June 1st at 10am, in 2128 Rayburn, the House Financial Services Committee will hold a hearing to receive the Treasury Department's annual report on the state of the international financial system. Treasury Secretary Timothy Geithner is scheduled to testify.

On Wednesday, June 1st at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Domestic Monetary Policy and Technology will hold a hearing on liquidity programs at the Federal Reserve.

On Thursday, June 2nd at 10am, in 2128 Rayburn, the House Financial Services International Monetary Policy and Trade Panel will mark up draft legislation that would reauthorize the Export-Import Bank of the United States.

On Friday, June 3rd at 10am, in 2128 Rayburn, the House Financial Services Committee will hold a hearing on an independent study conducted by the Boston Consulting Group on a proposal to overhaul the Securities and Exchange Commission.