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ML Strategies, LLC

701 Pennsylvania Avenue, N.W.
Washington, D.C. 20004 USA
202-434-7300
202-434-7400 fax

www.mlstrategies.com

Jason M. Rosenstock
Cheryl Isaac
Direct dial 202 434 7478
jrosenstock@mlstrategies.com

FINANCIAL SERVICES REGULATORY REFORM UPDATE

For the Week of July 12, 2010

On Thursday, the Senate (finally) voted 60-39 to approve the Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The legislation is now on its way to President Obama, who is expected to sign it into law this week. The one missing vote is that of the Sen. Byrd's replacement, Carte Goodwin, who was only named by the West Virginia governor on Friday, and will be sworn in on Tuesday. Three key Republicans – Senators Snowe, Collins and Scott Brown – also voted for Dodd-Frank.

The White House and their Congressional allies are attempting to spin the passage of the financial reform legislation as a major victory for the Obama administration. However, the true measure of the success of this legislation (beyond whether it actually prevents another economic crisis) will be the political realities in the upcoming election. Democrats continue to believe that they can harness the populist anger against Wall Street by campaigning on their passage of Dodd-Frank and other anti-corporate measures, as a means of mitigating voter dissatisfaction by midterm elections in November. Republicans are already beginning to campaign on repealing the law, similar to their efforts on health care.

It is important to note that while Dodd-Frank is sweeping in its reforms, the legislation will only serve as a framework for the hundreds of rulemakings still to come, which will ultimately be the real implementation of the measure. As Senate Banking Committee Chair Chris Dodd (D-CT) stated, "Congress has 12 months to make most changes, as many provisions do not take effect for a year." Though the President hasn't yet signed the bill into law, a technical corrections bill is already being discussed on the Hill. House Financial Services Chair Barney Frank (D-MA) is expected to begin work on this later in the year, to clarify the intent of Congress in several areas. Dodd has also stated that he intends to specifically clarify new provisions on derivatives to protect end-users from expensive new margin and collateral requirements on existing contracts. He also wants to ensure that the SEC and CFTC have clear instructions to follow the exact intent of Congress.

POST-DODD-FRANK: THE REAL ACTION

Perhaps Deputy Treasury Secretary Neal S. Wolin put it best late last week, when he said that Dodd-Frank is not "fixed and brittle" and "creates a clear, full framework… and gives regulators the authority and also the explicit direction to act." Essentially, financial regulatory reform is incomplete and will be until the legislation is actually implemented through regulation by the relevant federal agencies. According to the U.S. Chamber of Commerce, the Wall Street Reform and Consumer Protection Act includes provisions calling for as many as 355 potential new rulemakings where regulators have the authority to act. The

Financial Services Roundtable also performed its own tally and determined that the conference report included 199 provisions for agency rulemaking and 68 provisions for studies to be conducted. The American Bankers Association is estimating the commercial banks are likely to face as many as 5,000 new pages of regulations.

Regardless of the exact numbers, it is safe to say that financial regulatory reform is not "over" or "settled." In fact, a significant amount of lobbying and outreach is expected to occur, both at the agency level and continuing in Congress, because of the massive amount of rulemaking that is about to take place over the next couple of years. Some insiders emphasized the importance of new rules made at the Consumer Financial Protection Bureau (CFPB) and other agencies because the rules will be setting a precedent and will be harder to overturn down the road.

Notably, new capital requirements for banks will likely be determined by international negotiations for the new Basel accord, which are expected to be completed by the end of the year. Once those negotiations are made, they will have a major effect on how U.S. regulators choose to act. The Volcker Rule, which bans proprietary trading by large banks and limits their investments in hedge funds and private equity groups, still has some aspects that are yet to be determined. Regulators will need to determine the definition of a "permitted activity" under the provision, and what would constitute a conflict of interest between a bank and its client.

Additionally, the SEC and CFTC will be implementing rules for the OTC derivatives market, and Dodd-Frank grants both agencies new authority to impose margin requirements on commercial firms that use derivatives. The International Swaps and Derivatives Association expressed concerns that the language could require companies to post as much as $400 billion in collateral with dealer counterparties, but Senators Dodd and Lincoln hoped to allay these fears by issuing a joint letter stating that regulators should not "unnecessarily divert working capital" in their rulemaking. Another highly anticipated rulemaking will occur at the SEC, which has been tasked with issuing a rule to determine the level of duty to be imposed on stockbrokers and agents selling variable annuities. At issue is whether the Commission will require these individuals to act in the fiduciary interest of their clients, in a manner analogous to an investment advisor fiduciary duty under current law. In addition to granting this authority, the legislation also requires the SEC to perform a study within 6 months of the bill's enactment to determine the best way to implement this new fiduciary standard.

CFTC Chair Gary Gensler echoed Deputy Treasury Secretary Wolin's sentiments about financial regulatory reform being "far from complete," and in fact has already organized CFTC staff around 30 topic areas in which rules will need to be made. Gensler set up an implementation timeline for the CFTC, whose staff will be discussing rulemaking projects with other government agencies immediately, followed by a series of public hearings in September, and then publishing proposed rules later in the fall. In addition to areas the CFTC has already been regulating, it is also picking up new jurisdiction over data repositories and regulating swap dealers.

The government sponsored enterprises - Fannie Mae and Freddie Mac - were not dealt with at all in Dodd-Frank. The administration is undergoing discussions on how to effect changes in these organizations and U.S. housing finance, and will announce those changes in 2011, according to Wolin. He added that while regulatory reform was the number one priority in addressing the health of the U.S. financial sector, reforming the U.S. housing finance system is also a major focus of the administration. Wolin stated that GSE's play an overly large but necessary role in housing finance, by helping to stabilize the market and allowing individuals to purchase homes. However, he added that the system cannot continue to operate as it has in the past, and the Treasury will be issuing proposals and recommendations in early 2011.

THE UNNAMED CONSUMER FINANCIAL PROTECTION BUREAU DIRECTOR

President Obama will have the task of appointing the first five-year director of the new Consumer Financial Protection Bureau (CFPB), which will be housed at the Federal Reserve and have an initial budget of $500 million. Rumors abound as to who his pick might be, with consensus amongst liberal activists coalescing around Harvard professor Elizabeth Warren, with a small, but vocal minority for the Assistant Secretary for Financial Institutions, Michael Barr. Warren is currently the head of the Congressional Oversight Panel that oversees the Troubled Asset Relief Program, she was the Chief Advisor to the National Bankruptcy Review Commission, and she currently serves as a member of the Commission on Economic Inclusion established by the FDIC, among many other accomplishments. She has the strong backing of House Financial Services Chair Barney Frank (D-MA) and Rep. Brad Miller (D-NC), who led the push in the House for tighter consumer protections in the mortgage lending industry, but her appointment would be anathma to most Republicans (and some conservative Democrats as well) .

Barr, in addition to his position at the Treasury, is also a member of the FDIC Advisory Committee on Economic Inclusion, was a senior fellow at the Center for American Progress and the Brookings Institution, a law professor at the University of Michigan, and the lead Treasury negotiator during the Dodd-Frank bill negotiations. He is viewed as second to Warren, and perhaps a more apt pick for the Office of the Comptroller of the Currency. However, on Friday it was reported that Treasury Secretary Timothy Geithner expressed his opposition to the possible nomination of Warren to the head of the CFPB.

Others rumored to be on the CFPB chief short list are Martha Coakley, the Attorney General of Massachusetts, Allen Fishbein, an advisor within the Fed's Division of Consumer and Community Affairs, and Lisa Madigan, the Illinois State Attorney General. Other potential appointees include Nicolas Retsinas, the director of Harvard University's Joint Center for Housing Studies; Ellen Seidman, the Executive Vice President of Mission and Strategy at ShoreBank; Eric Stein, the Deputy Assistant Secretary for Consumer Protection in the Treasury's Office of the Under Secretary for Domestic Finance; Lori Swanson, the State Attorney General for Minnesota; and Susan Wachter, a professor at the University of Pennsylvania's Wharton School and a consultant on real estate and housing market issues.

POTENTIAL DIVIDEND TAX INCREASE

On January 1, 2011, some key tax cuts from 2001 and 2003 are set to expire, and on Wednesday, Senate Finance Committee Chair Max Baucus (D-MT) held a hearing to determine which of these tax cuts should be extended. Most notably, without congressional action, the maximum tax rate on dividend income is set to rise from its current level of 15% to 39.6%. When the 2.8% health care surtax on individuals earning more than $200,000 per year, or couples earning more than $250,000 per year, is effectuated in 2013, the dividend tax could actually be the highest income tax in the country.

Baucus has stated that he intends to seek the middle ground with his counterparts, and strongly asserted that "we can't let dividends go to ordinary rates." Some interest exists in keeping the dividends tax rate tied to the top capital gains rate, but Baucus would not respond to questions about whether he would support this approach. In addition to the tax rate itself, Lawmakers will have to determine whether to extend the tax cuts permanently or temporarily. President Obama has stated his support for making the tax cuts permanent, and only subjecting high-income households earning more than $200,000 per year to higher individual income tax rates. Many Democrats support this proposal, and the Joint Committee on Taxation determined that the total cost would be $2.5 billion over 10 years.

House Majority Leader Steny Hoyer (D-MD) has also proposed that the tax cuts be extended temporarily - for two years - so that Congress has more time to consider which tax cuts should be permanent, in light of federal budgetary problems. Regardless of how Congress chooses to act, the deadline for extending any of the tax cuts is looming, and no definite action appears imminent. As a result, many tax planners are urging high-income clients to assume that their taxes will rise.

GOLDMAN SETTLES WITH SEC

On Thursday, SEC officials stated that Goldman Sachs has agreed to a $550 million payment to settle federal claims that it misled investors in a structured finance product in 2007. A federal judge in Manhattan still has to approve the settlement before it is finalized. The settlement is considered a partial victory for Goldman, whose profits were reported to be $13.39 billion last year. News of the settlement pushed Goldman stock up 5% in after-hours trading, which added more to the firm's market value than it will have to pay in the settlement.

Although the settlement amount may only be a small dent in Goldman's deep pockets, it will be one of the largest settlements in the history of the SEC, and some say an acknowledgement of Goldman's wrongdoing. The SEC contended that Goldman misled investors by not disclosing that a hedge fund client was betting against a single mortgage security that the firm created. By settling, Goldman is not conceding that the SEC's allegations were correct, but the firm did agree to a judicial order barring it from committing international fraud in the future under federal securities laws. Goldman also acknowledged that that marketing materials for the financial product in question "contained incomplete information" and that it was a "mistake" not to have disclosed the role of the hedge fund betting against the product.

Although this settlement will end this particular SEC investigation, Goldman could still face other legal battles. The SEC is continuing to investigate other collateralized debt obligations that Goldman issues, the Department of Justice is looking into the same financial product that led to Goldman's settlement, and Goldman is also facing private lawsuits related to certain mortgage securities and its decision not to tell its shareholders about the SEC's investigation that began last year.

Goldman will be paying back $15 million in profit, and the $550 million settlement is a civil penalty. Of that latter portion, $150 million will go IKB Deutsche Industriebank and $100 million to Royal Bank of

Scotland Group (the two banks that had losses on the deal). The remaining $300 million will go to the U.S. Treasury as a fine.

IMPENDING EUROPEAN CREDIT CRUNCH

Trillions of dollars in short-term borrowing will be reaching their due date in the next two years, which could have particularly disastrous effects in Europe, where banks already have trouble raising money. Both European banks and governments will be rolling over huge sums of money, and will be competing for an edge in the bond market. In consequence, credit for businesses and consumers could become more expensive and scarce, and have grave ramifications for economic growth.

UPCOMING HEARINGS

On Tuesday, July 20th at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Subcommittee on Security and International Trade and Finance will hold a hearing on international cooperation to modernize financial regulation.

On Tuesday, July 20th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises will hold a hearing entitled "Oversight of the U.S. Securities and Exchange Commission: Evaluating Present Reforms and Future Challenges."

On Tuesday, July 20th at 10am, in 2175 Rayburn, the House Education and Labor Subcommittee on Health, Employment, Labor and Pensions will hold a hearing entitled "Creating Greater Accounting Transparency for Pensioners."

On Wednesday, July 21st at 10am, in 215 Dirksen, the Senate Finance Committee will hold a hearing entitled "An Update on the Troubled Asset Relief Program."

On Wednesday, July 21st at 10am, in G-50 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing to receive the semiannual monetary policy report of the Federal Reserve Board.

On Wednesday, July 21st at 10am, in 2128 Rayburn, the House Financial Services Committee will hold a hearing entitled "Multilateral Development Banks: Administration Perspectives on General Capital Increase and Other Reform Proposals."

On Wednesday, July 21st at 1pm, in 2128 Rayburn, the House Financial Services Committee will hold a hearing on H.R. 2267, the Internet Gambling Regulation, Consumer Protection and Enforcement Act.

On Thursday, July 22nd at a time TBA, in 2128 Rayburn, the House Financial Services Committee will hold a hearing on monetary policy and the state of the economy.