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FINANCIAL SERVICES REGULATORY REFORM UPDATE

Week of December 13th -17th, 2010

As Congress closes in on its threat of being in session to Christmas Eve, it seemed as if two significant measures (the tax bill and FY11 appropriations bill) were on the path towards enactment. However, by the end of the week only one of those bills – the $858 billion dollar tax cut extension – had made it to President Obama's desk for signature. Although much media attention was devoted to the fact that the legislation passed by wide margins in both houses (with nearly two-thirds of both bodies voting in favor) as evidence of new found bipartisanship, it seemed that those high hopes had evaporated as quickly as they had materialized when Senate Majority Leader Harry Reid was forced to pull the omnibus spending bill on Thursday evening. Although the bill had initial support from key Republican's, including Senate Minority Leader Mitch McConnell, this support dwindled after pressure from conservative groups in large part in response due to earmarks, including spending supported by Republican's like McConnell, in the bill. McConnell is instead proposing a two-month "clean" one-page extension of the current continuing resolution, which is set to expire this week.

We believe that two distinct ways that these bills moved (or didn't move) provide critical insight into how legislation will be able to move in the upcoming Congress and the political sensitivity afforded to the Tea Party and concerns about any new spending measures. Perhaps most fascinating is that any legislation that significantly added to the deficit was able to be enacted only two short weeks after so much attention was devoted to the President's Budget Deficit Commission and the need to rein in spending.

This is the last update for 2010, but we look forward to continuing to provide you our insight and analysis next year. In the interim, we again wish all of our readers a Happy Holiday and a safe and healthy New Year.

SEC PROPOSES SECURITY-BASED SWAPS RULES

Continuing with its ongoing implementation of the Dodd-Frank bill, this past week the SEC voted unanimously to propose two new rules on security-based swaps. The first rule would create requirements for end-users when they engage in a security-based swap transaction that is not subject to mandatory clearing. Under the rule, end-users would have to take specific steps to notify the SEC of how they meet their financial obligations when engaging in these non-cleared security-based swaps. The SEC is also seeking comment on whether an additional exemption from mandatory clearing should be granted to certain financial institutions. SEC Chair Mary Schapiro stated, "This proposal lays out the critical types of information that entities must provide in order to qualify for the end-user exception… Importantly, the proposal seeks to prevent abuse of the end-user clearing exception by requiring a non-financial entity to notify the SEC each time it elects to use the exception."

The second regulation proposed by the SEC on Wednesday elucidates how clearing agencies will provide information to the SEC about security-based swaps that the agencies plan to accept for clearing. This information is intended to help the SEC determine whether the swaps are actually required to be cleared. The SEC also proposed a rule that sets out how clearing agencies that are designated as "systemically important" must submit advance notices for changes to their procedures and operations that could materially affect the level of risk at the clearing agencies. Schapiro stated that "Promoting clearing wherever possible and appropriate is key to building a regulatory framework for the derivatives market… Through the clearing process itself, regulators will be more easily able to monitor transactions including prices and positions taken by traders, and thereby rein in the risks associated with these instruments."

Public comments on the proposed rules are due to the SEC within 45 days after they are published in the Federal Register, which should be around January 30, 2011.

OVERSIGHT PANEL BASHES OBAMA'S HAMP PROGRAM

The Congressional Oversight Panel released its report of the Treasury Department's Home Affordable Modification Program (HAMP) on Tuesday, stating that the effort to help trouble homeowners avoid foreclosure has been unsuccessful and is "unlikely to improve substantially in the future." Although the Treasury had intended to stop 3-4 million foreclosures, instead HAMP will more likely prevent 700,000 to 800,000, and only spend about $4 billion of its allotted $30 billion from the Troubled Asset Relief Program. The Panel's report blamed Treasury officials from changing HAMP before their ability to do so expired in October – "many billions of dollars… may well be left unused… [and] an untold number of borrowers may go without help – all because Treasury failed to acknowledge HAMP's shortcomings in time." The acting Assistant Director for Financial Stability at the Treasury, Timothy Massad, responded that "the important thing to keep in perspective is what the program has accomplished," which includes setting an "industry standard" that lead to 2 million privately conduct mortgage modifications to avert foreclosure.

FED PROPOSES INTERCHANGE FEE RESTRICTIONS

The Federal Reserve announced a highly controversial rule proposal on Thursday that would limit the fees that banks can charge their debit card customers. Currently, payment networks such as Visa and MasterCard charge merchants an average of 1% of the consumer's purchase price, regardless of the cost of transaction, and pass that money along to the banks that issue the debit cards. The Fed proposed that this fee be capped at 12 cents per transaction, which would effectively wipe out the $16.2 billion in revenue that was generated by debit cards in 2009. This is yet another new policy created by Dodd-Frank. The proposed rule will go through a public comment period, and if approved by the Fed at the end of that period in February, final rules will be complete in April and put in place by July. However, if a second round of comments is needed, this would likely delay this process.

This is clearly going to be a very contentions rulemaking, and given the legislative battles witnessed previously on the hill between retailers and the payment processing systems, it was little surprise to see Rep. Barney Frank, outgoing Chairman of the House Financial Services Committee and co-author of the Dodd-Frank legislation, send a letter to the Fed on Friday stating his concerns with the proposed rule.

Specifically, Frank stated that he is "concerned that the implementing regulations for this section, if not properly crafted, may have unintended consequences for consumer choice, the protection of consumer information, and Congress' intent to reduce burdens on community banks, credit unions, and government benefit programs." Wall Street analysts had expected there to be a 50% reduction in fees, but the Fed's proposal would be closer to 84%.

In addition to the financial sector trade groups and analysts who quickly denounced the proposed rule, the American Bar Association also expressed its disappointment with the proposal, saying that it doesn't account for a range of costs that interchange fees cover. These costs include customer service expenses, the cost of issuing cards, maintaining and supporting networkers, among other things. Across the Atlantic, however, Europe is handling this problem in a different fashion – just this week, the European Commission proposed to establish a deadline for the end of 2012 by which all fees for direct debit payments must be eliminated. Initially the governmental body had relied on self-regulatory efforts by the European banking and credit card industry, but this has been ineffective as a means of establishing a Single Euro Payments Area (SEPA). The SEPA would have established a seamless system of cross-border payments without any hidden fees for consumers and businesses, but the EC did not see the rapid migration to this program that it had anticipated.

OHIO ATTORNEY GENERAL SELECTED FOR HEAD OF CFPB ENFORCEMENT

In perhaps her first major decision for the new Consumer Financial Protection Bureau (CFPB), Elizabeth Warren selected Ohio Attorney General Richard Cordray to lead the enforcement team. Cordray has experience with mortgage issues and has been a major participant in multi-state investigations of mortgage servicers over allegedly falsified documents. In November, Cordray sued GMAC LLC and Ally Financial Inc. for fraudulent affidavits in court cases over foreclosures. His office is also managing litigation against Bank of American and AIG. Warren stated that Cordray will be a tough "cop on the beat" in his enforcement efforts, and he "has the vision and experience to help us build a team that ensures every lender in the marketplace is playing by the rules." Cordray had just lost in the November, will still have to be confirmed by the Senate. Additionally, the CFPB named a number of other appointments (which don't necessitate Senate confirmation) and based on our conversations with the people standing up the Bureau they continue to believe that they will be ready to begin operations by July 21, 2011.

BABS PROGRAM UNLIKELY TO BE EXTENDED

An extremely popular bond subsidy program – Build American Bonds (BABs) – will not be extended beyond its current term, and on news of this likely expiration, investors demanded higher interest payments on municipal bonds which pushed yields to their highest level since 2009. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, signed into law by President Obama on Friday, did not include an extension of the BAB program. BABs had opened the market to considerably more investors because it created a federal subsidy for taxable bonds issued by state and local governments, and the increased yields are a result of the fears that these governments will have a hard time selling debt without the subsidy program. Rep. Dave Camp (R-MI), incoming Chairman of the House Ways and Means Committee, stated his support for the expiration of the subsidy program because it was created by a "failed stimulus" law and "simply subsidized state and local governments going deeper into debt."

FDIC SEEKS COMMENT ON BANK CAPITAL STANDARDS

Earlier this week, the Federal Deposit Insurance Company board of directors unanimously voted to clear two proposals – one that would set a new minimum for risk-based capital requirements and another that would update how large banks assess risks for their trading operations. The capital requirements proposed rule was based on an amendment in Dodd-Frank proposed by Sen. Susan Collins (R-ME), and will require large financial firms to calculate their minimum capital based upon the same general terms as their smaller peers. This rule would remove the transitional capital floors allowed under previous rules, and would make general risk-based requirements a permanent floor. FDIC Chairman Sheila Bair stated that "The Collins Amendment, in my view, will do more to strengthen the capital of the U.S. financial system than any other section of the [Dodd-Frank] Act."

The second proposed rule will require banks to set aside even more capital, even if they have scaled back on trades, when combined with other Dodd-Frank prohibitions on bank investments and hedge fund ownership. Some in the industry believe that rewriting the market-risk rules will "redefine U.S. financial markets." The comment period will last for 60 days for the minimum capital rule, and for 90 days on the rule on risk assessment.

EXECUTIVE COMP DISCLOSURE AND SAY-ON-PAY RULES MAY POSE CHALLENGES IN UPCOMING PROXY SEASON

As the proxy season approaches, public companies are expected to have challenges in preparing for new say-on-pay requirements mandated by Dodd-Frank, and by continued compliance with executive compensation disclosure rules. Under Dodd-Frank, companies have the choice of determining the frequency of voting on say-on-pay every one, two or three years. Industry experts expect that smaller companies will prefer a yearly vote, although this will increase costs and may shift attention away from long-term incentive pay plans. The SEC adopted enhanced executive compensation disclosure rules in 2006, and amended them in 2009, requiring that public companies draft Compensation Discussion and Analysis (CD&A) documents. As a result, lawyers have their work cut out for them in terms of drafting the documents, presenting to a compensation committee and board, and responding to comments from the SEC.

In response to the SEC's relatively new say-on-pay rules, Attorney Pamela Greene of Mintz Levin has be recommending executive summaries as a means of getting the most relevant information up front in the CD&A: "In order to connect with shareholders who may stop reading after the first few paragraphs, companies need to tell them 'why' in the beginning. The summary should also link 'pay for performance' (i.e., How did company performance or stock price tie to compensation? And how did compensation decisions made last year tie to performance?) With say-on-pay, the CD&A should be both a disclosure piece and an advocacy piece."

FRANK RESPONDS TO BACHUS COMMENTS ON GOVERNMENT OVERSIGHT OF BANKS

On Wednesday, House Financial Services Chairman Barney Frank responded to incoming Chairman Spencer Bachus' statement that: "Washington and the regulators are there to serve the banks." Frank retorted that Bachus' assault on financial reform legislation is based on a seriously flawed view of the relationship between regulators and financial institutions. Frank also said that Bachus' staff will have to work very hard getting Bachus to retract his flawed statements. Although Bachus walked backed is statement it will be interesting to see how Democrats attempt to use the incoming Chairman's agenda for political purposes, since there is a strong belief in the Democratic caucus that the Dodd-Frank bill is politically popular, in large part because it would appear that the banks are the only institutions less popular than Congress.

REP. RON PAUL DISCUSSES PLANS FOR FED OVERSIGHT

One of the most celebrated libertarians in recent history, Rep. Ron Paul (R-TX) will be the new chair of the House Financial Services Subcommittee on Domestic Monetary Policy and Technology, which has oversight responsibility over the Federal Reserve, currency and monetary policy. Paul believes that the government should have no role whatsoever in regulating the economy, and opposes the existence of the Fed. In a recent CNN Money article, Paul discussed his plans for the 112th Congress and his distaste for quantitative easing, among almost every other Fed initiative. Paul has stated in the past that he plans to push for a more comprehensive audit of the Fed, and elucidated that he wants to understand who the beneficiaries of this programs are. He advocates for ending the Federal Reserve entirely, but believes that it will implode on its own accord over time. Paul believes that the world should return to the gold standard, and that eventually as the world gives up on the dollar, people will start using gold as money. He did not rule out running for President in 2012.

BUDGET STALEMATE SLOWS DOWN SEC

While the SEC is operating under a "continuing resolution" (i.e., the same budget that it was meted in FY2010, before the enactment of Dodd-Frank), its resources are being stretched thinly, according to Chairman Mary Schapiro. As a direct result of the lack of congressional increase in funding, the agency has postponed gathering testimony from witnesses in a number of recent investigations, and put off previously scheduled audits of financial firms. An SEC spokesperson stated that the agency is taking the "usual steps just like any other government agency under a continuing resolution, which include restrictions on non-essential travel, hiring and contracts." The agency proposed a 12% budget increase, and in fact a 19% increase was included in the Omnibus Appropriations bill released by the Senate Appropriations on Tuesday (which may be moot for the time being).

ASPPA EXPRESSES CONCERN WITH DOL'S PROPOSED DEFINITION OF "FIDUCIARY"

The Labor Department's proposed expanded definition of a fiduciary could have repercussions in the retirement plan market, according to the Brian Graff, the CEO of the American Society of Pension Professionals and Actuaries. On a recent webcast run by his organization, Graff said that conferring fiduciary status on vendors that sell retirement plans or provide employer stock appraisals "is a major change" and getting paid a commission based on investment menu options could be considered self-dealing under the proposed definition.

The proposed regulation expands the standards for determining whether a person or entity that gives investment advice to an employee benefit plan fiduciary, plan participants or beneficiaries is a fiduciary. The broader standards for defining investment advice would apply to many vendors in the retirement plan market. The proposed regulation would also apply whether the advice is given directly or indirectly and would cover entities that make stock appraisals of employee stock ownership plans.

SUMMERS DELIVERS LAST POLICY SPEECH AS NEC DIRECTOR

National Economic Council Director Lawrence Summers, who is returning to Harvard University at the end of the year, spoke out this week in defense of the Obama administration's tax compromise with the GOP. At an Economic Policy Institute event, Summers stated that the economy has a long way to recovery, which will be lengthened by the lack of demand that will last for several years. In order to counter this dearth, he believes that it is the right move for the government to deleverage households and businesses, which will be accomplished by the just-passed tax extenders bill. Last week, Summers had warned that the economy could have dipped into another recession if Congress failed to pass the extension. He noted that many industry forecasters have increased their growth and employment forecasts for 2011 as a direct result of the agreement. Summers also called for increased exports and infrastructure spending in the short-term, combined with more emphasis on education, innovation, and reining in the federal budget deficit in the long-term. Summers' successor has not yet been named and White House Press Secretary Robert Gibbs has indicated that a successor may not be named until 2011.

UPCOMING HEARINGS

Although the Senate will be considering a handful of remaining issues this weekend and perhaps into next week, no new hearings have been scheduled in either chamber in preparation for the holiday recess.