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FINANCIAL SERVICES REGULATORY REFORM UPDATE

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Once again the news this week was dominated by debate surrounding the federal budget, deficit reduction and the looming vote to extend the debt ceiling. The week began with Speaker Boehner making a speech before the Economic Club of New York on Monday and closed with a report from the trustees for Social Security and Medicare that warned that the funds will reach insolvency sooner than anticipated. In the interim, President Obama separately met with Democratic and Republican members of the Senate to discuss these issues and the U.S. Treasury came within a hair's breadth of breaching the debt limit with a bond sale on Thursday.

The other major news this past week was the admission by the FSOC at a Senate Banking Committee hearing on Thursday that it would be revisiting its definition of systemically important financial institution ("SIFI") and that the SIFI rules, initially anticipated by mid-summer 2011, will be pushed back at least until mid-fall. This is a clear victory for the insurance companies, asset management firms, mutual funds and other non-bank financial institutions who were concerned about an overly broad SIFI definition that would have ensnared companies and firms under the regulation of the Fed, as well as the other regulatory burdens that a SIFI designation encompasses, such as the need for a living will.

With the House in recess this week, and the Senate Banking Committee taking up a relatively light schedule, we continue to anticipate the week to be dominated by the debt ceiling and intertwined issues of the budget and the need for deficit reduction, though it is unlikely that any major breakthrough will be achieved.

US NEARS DEBT CEILING -- BUDGET NEGOTIATIONS CONTINUE

House Speaker John Boehner (R-OH) spoke to a skeptical audience at the Economic Council of New York on Monday, stating his preference for a successful compromise in the short-term on deficit reduction, in exchange for raising the debt ceiling, while putting off corporate tax reform for some time in the next two years. He asserted that there is a "hard date on the fiscal 2011 budget… [but] there is really no hard date when it comes to increasing the debt limit." Boehner also suggested a means-test for Medicare benefits as a method for balancing the budget in the long-term.

Although Treasury Secretary Timothy Geithner now believes that the debt ceiling will be breached in early August, the U.S. Treasury was within "within a whisker" of this limit after its latest round of bond sales this week. The Thursday sales did not attract as much demand as expected, though in general buyers have not been scared away by fears of the U.S. defaulting on its debt. The Treasury has stated that it will take "extraordinary measures" to prevent a potential default, and international industry experts have stated their confidence in U.S. Treasuries as "safe investments."

In the meantime, Senate Minority Leader Mitch McConnell (R-KY) attended what he called a "candid exchange" at the White House on Thursday between Senate Republicans and the President. (Obama met with Senate Democrats the day before). After this discussion, McConnell listed his conditions for supporting an increase in federal debt, which included enforceable short-term caps on annual appropriations, spending reductions in both mandatory and discretionary programs over 5-10 years, and tackling long-term potential liabilities from entitlement programs. He was skeptical that this Congress would reform Social Security (instead it will likely turn to health care entitlements), and that tax reform will be tied to raising the debt limit because of the short window before August 2nd.

McConnell and Boehner have both made optimistic statements about the White House's involvement in the budget and debt negotiations, particularly the meetings taking place with Vice President Biden in recent weeks. The bipartisan Group of Six Senators is working on a budget plan, and the House passed a GOP budget that would cut the deficit solely with spending cuts, but McConnell believes that Biden's working group may be the one with the most potential for progress. Vice President Biden spoke about negotiations that took place in his office on Thursday, stating that some compromises were coming along, but that there are still many issues to be fleshed out: entitlements, mandatory spending and discretionary spending. Biden added that "it's all open for discussion," and all issues are on the table, even if the parties will never agree on items like taxes or long-term Medicare costs.

At a National Economists Club meeting on Thursday, Mark Zandi, a political analyst and chief economist at Moody's Analytics Inc., spoke optimistically about the United States' economic forecast. Because of this bullishness, he stated that it is "perfectly reasonable" for the U.S. to absorb $4 trillion in spending cuts over the next decade. Although he didn't come out in favor of any specific proposals, Zandi advised against spending cuts that are not accompanied by an increase in the debt limit. He asserted that global investors will begin to ask themselves, "how long can policymakers pay me and not a Social Security recipient," which will cause them to run from U.S. Treasuries.

SENATE BANKING COMMITTEE GRILLS FSOC ON SIFI DESIGNATION RULES

On Thursday, the Senate Banking Committee called all representatives of the Financial Stability Oversight Council (FSOC) to testify, ostensibly for an oversight hearing on Dodd-Frank implementation. Instead, the focus of the hearing was largely on the designation process of systemically important financial institutions, or SIFIs. It was clear that the committee members, both Democratic and Republican, were not pleased with the FSOC's draft rules for making this determination and the consensus of the committee was that regulators must provide more clarity as to the process for designating a firm as a SIFI. In response, the regulators assured the committee that additional guidance would be forthcoming this summer. Senator Toomey pushed for the FSOC to resubmit the matter as a new notice of proposed rulemaking (NPRM), with an attendant 60-day comment period. It was unclear based on the comments of the panel whether the FSOC would do this, but the panelists continued to stress they would issue new guidance on which the public could offer comment, and that they felt a 60-day comment period seemed reasonable. At issue is the fact that in its initial NPRM, released in January, the FSOC offered very little clarity as to what factors they would take into account in making their determination as to what qualifies a financial institution as a SIFI. In our opinion, outgoing FDIC Chair Sheila Bair offered the best insight into the FSOC's reasoning when she said that if an institution can be effectively resolved through the bankruptcy process, it should not need to be designated as a SIFI. However, the FSOC, and not the institution, will have to make that determination, which would mean that companies would still have to share their books with the FSOC under that scenario. This issue of FSOC SIFI determinations is one that many financial institutions are just realizing is very important, and we continue to anticipate significant lobbying, both in Congress and the Administration, in the coming months.

Coincidently, the day before the hearing, the FDIC announced the creation of a systemic resolution advisory committee in order to aid in implementing Dodd-Frank mandates for resolving large non-bank financial institutions. The head of the FDIC's Office of Complex Financial Institutions also announced that his department now has 150 employees in three major task areas: reviewing "living wills" of the largest institutions, monitoring for risks in the economy, and reviewing cross-border issues for banks' resolution plans. The FDIC also announced a NPRM for specifics on the required contents of resolution plans ("living wills"), filing requirements and joint review of the plans. The rule would require firms to submit their plans to the FDIC and Fed for initial review, the agencies would determine if the plan is credible, and if not they would issue a joint order of deficiency requiring the firm to resubmit a resolution plan. If the resubmission is still insufficient, the agencies would have the authority to require an orderly liquidation, which would include divesting certain business units. The proposed rule is based on analogous resolution authority for insured banks under the Federal Deposit Insurance Act. Comments are due by June 10th.

In addition to the SIFI issue, the Democratic members of the committee used the hearing as an opportunity to focus on the need to fill the various vacancies that exist at high levels of financial regulatory agencies such as the CFPB, OFR and other vacancies within regulatory bodies that comprise the FSOC. Senator Warner also raised the issue of the international harmonization of regulatory rules on financial institutions, which is also going to be important issue, as earlier in the week the Financial Stability Board (FSB), a group of financial regulators and central bankers from the world's largest economies, announced that they will be proposing criteria for the definition of a "systemically important financial institution" (SIFI) this July. Assuming the group stays on target, formal recommendations will then be made to the G20 countries in November on these designations and the amount of additional top quality capital these institutions will be required to hold against potential losses. Reportedly, support is growing in the FSB for graduated capital surcharges that increase progressively based on the bank's size, its level of financial interaction with other banks, and how easily the bank could be replaced in case of a crisis. There would be between three to six tiers of SIFI charges on top of the global capital minimums already set by the Basel committee on banking supervision. It appears that the kind of securities that can cover the surcharge is also still up in the air – the FSB is mulling over allowing a larger volume of contingent capital in place of equity, which is considered to be the safest. Additionally, a handful of countries are still pushing for one flat rate across the board.

If true, then it would seem that the largest U.S. and European banks would bear the brunt of these new regulations, although it is still to be determined how national regulators apply these surcharges to the SIFIs in their jurisdiction. Conversely, it would appear that second-tier U.S. and European banks, along with large Chinese and Japanese institutions, all of whom generally do most of their lending domestically stand to benefit from this system.

WAYS AND MEANS COMMITTEE DISCUSSES TAX REFORM

The House Ways and Means Committee held a hearing on Thursday to examine the need for comprehensive tax reform in order to help U.S. companies compete internationally and create jobs for American workers. There were two panels of witnesses, the first composed of chief financial officers from United Technologies, Caterpillar, Zimmer Holdings and Kimberly-Clark, and the second composed of industry experts from the University of Michigan Law School, Covington & Burling and the Congressional Research Service (CRS). The first panel unanimously agreed that the Congress should institute a territorial income tax system as a means of simplifying the tax code and making the U.S. more competitive internationally. The United States is the only major economy in the world that taxes income regardless of where it is earned, and requires the use of complex methods such as foreign tax credits and deferral rules.

Ways and Means Chair Dave Camp (R-MI) stated after the hearing that he would consider supporting a territorial income tax system, though many details would first need to be fleshed out. Democrats on the committee, however, expressed reservations that this might cause U.S. businesses to invest in countries with lower tax rates, knowing that they could repatriate profits with little or no tax. The CRS representative added that her research demonstrates that a purely territorial system would reduce investment in the U.S. and could actually drive down wages. Camp disagreed, stating that this might instead create an opportunity for foreign companies to invest in the U.S. As we've previously shared, it is rumored that a transition to a corporate territorial tax system is in consideration as part of the Gang of Six negotiations.

HOUSE GOP MEMBER INTRODUCES ALTERNATIVE GSE REFORM BILL

Although the Republican party line on housing finance reform has been almost entirely focused on full privatization, Rep. John Campbell (R-CA) crossed the aisle to drop a bill with Rep. Gary Peters (D-MI) that left intact a role for the federal government. On Thursday, the two members introduced H.R. 1859, which would replace Fannie Mae and Freddie Mac with a number of private companies that would issue mortgage-backed securities with the full backing of the federal government. House Financial Services Chair Spencer Bachus (R-AL) stated that there is a "difference of opinion," and in the past has said that his committee's goal is to report out a bill sponsored by Rep. Jeb Hensarling (H.R. 1182), which would privatize the government sponsored enterprises (GSEs) fully within 5 years. Rep. Scott Garrett (R-NJ) also introduced another package of smaller, leadership-supported bills that would gradually phase out Fannie and Freddie. Considering this lack of agreement within the GOP, let alone across party lines, we do not expect GSE reform to occur anytime in the near future.

TREASURY OFFICIAL DISCUSSES CARRIED INTEREST TAX TREATMENT

The senior counsel in the Treasury Department's Office of Tax Policy, Robert Crnkovich, spoke earlier this week about the likelihood of reforming the tax treatment of partnership carried interest in the current political climate. In a nutshell, his answer was "doubtful." Crnkovich noted that the same proposal has been introduced and passed the House four times in the past four years, including most recently in H.R. 4213, the American Jobs and Closing Loopholes Act of 2010. The Obama administration supports the proposal, which also has a significant amount of backing in Congress, but "there isn't much that will happen in the short-term." Crnkovich added that "there is always a decent chance it will become law" in the future, as it continues to be proposed and passed by one of the chambers.

OCC TO IMPLEMENT DODD-FRANK PREEMPTION RULES

Earlier this week, the Office of the Comptroller of the Currency sent a letter to Sen. Tom Carper (D-DE) laying out the agency's plans to implement federal preemption provisions from Section 1044 of Dodd-Frank. Just before the letter went out, a federal appeals court decision was made on preemption, suggesting that much clarity is needed on how to understand and apply the new Dodd-Frank provisions. In light of this, Acting Comptroller of the Currency John Walsh wrote that the OCC will be proposing changes to 2004 preemption regulations that have led to years of litigation and policy battles, to remove any ambiguity for national banks and federal thrifts. Specifically, Dodd-Frank authorizes the OCC to supervise national banks and federal chartered savings associations, and the proposed rule will be illuminating application of identical standards for banks and thrifts under the National Bank Act and the Home Owners Loan Act.

Carper authored this amendment to Dodd-Frank while the law was still being drafted, and had requested that the OCC respond to certain questions about preemption. In response to the OCC letter, Carper stated that he was "glad to see that the Comptroller's view of these provisions is consistent with my intent…" Key players in the industry have also lauded the letter as "provid[ing] predictability about an important doctrine," and noted the benefit that new preemption standards will not apply retroactively.

SEC SOLICITS COMMENTS ON STRUCTURED PRODUCT RATING PROCESS

The SEC released a notice soliciting comment on a study it is required to conduct under Section 939F of Dodd-Frank, on the credit rating process for structured finance products. Specifically, the SEC must examine conflicts of interest that arise from current pay models, the feasibility of having a self-regulatory organization assigning rating agencies to rate structured finance products, and the range of metrics that may be used to assess the accuracy of the products' credit ratings. Comments are due 120 days after the notice is published in the Federal Register (roughly mid-September), and the SEC study must be complete and submitted to Congress by July 12, 2012.

SCHAPIRO OUTLINES PRIORITIES FOR POST DODD-FRANK REGULATORY AGENDA

In remarks before the Investment Company Institute, SEC Chair Mary Schapiro said the agency will be renewing its focus on non-Dodd-Frank related issues this summer. Schapiro said many issues that have long been on the agency's agenda "have had in some instances to take a bit of a second chair to the Dodd-Frank statutory deadlines." Among these issues, Schapiro cited Rule 12b-1 mutual fund distribution fees reform, investment advice/ broker-dealer issues (including uniform fiduciary standards for broker-dealers and investment advisors) and proposed consolidated audit trail.

In May 2010 the SEC proposed a consolidated audit trail rule requiring the creation of central data repositories for all self-regulatory organizations. The rule, which would allow the SEC to monitor trading in real time, is strongly opposed to by industry stakeholders who fear it would be costly to implement. In her remarks, Schapiro said the SEC would be finalizing an audit trail rule within the coming months and then the agency would proceed to consider Volatility Plans, market structure issues and a larger trader proposal. Schapiro also said that the agency would be addressing the underlying issues behind the flash crash of May 6th. Schapiro said that the SEC is also considering a number of reforms including imposing trading obligations and updating circuit breakers so that they accurately "reflect current levels of volatility."

MONEY MARKET FUNDS PARTICIPATE IN SEC ROUNDTABLE

At a May 10th SEC roundtable discussion on Dodd-Frank rulemaking, money market mutual funds voiced strong opposition to the new, bank-like regulatory structure to which they may soon be subjected. One roundtable participant, the Investment Company Institute, floated the idea of a special liquidity bank as a solution to emergency funding needs. Such a facility would be housed in the Fed, have direct access to the Fed's discount window and be structured as a commercial bank holding government and agency securities with short maturities.

In response to the special facility proposal, FDIC Chairman Sheila Bair said that it amounted to nothing more than "institutionalizing a bailout facility" for the funds. Additionally, Bair repeated the need to move to a floating net asset value (NAV) which would reflect changes in market risk. Roundtable participants were skeptical of the floating NAV saying that the funds depend on a stable NAV because it assures a safe principal. Bair's use of the "scarlet B" in characterizing ICI's proposal can only be seen as a concerted effort to stigmatize the proposal out of existence before it can be considered further since there is little appetite for bailouts in Washington, D.C.

GENSLER TELLS PE FIRMS THAT DERIVATIVES REGS WILL IMPACT THEM

CFTC Chair Gary Gensler spoke at the International Finance Corporation's annual conference on Wednesday, and told an audience of private equity fund managers that derivatives regulations will impact them because companies in which they invest use derivatives to hedge against risk (even if the PE funds do not directly invest in derivatives). Gensler noted that the vast majority of the 700 meetings that CFTC staff has held with the public have been with banks, hedge funds, asset managers, etc. – but not private equity funds. Gensler defended his agency's almost-complete Dodd-Frank rulemaking process, which includes dozens of rules aimed at regulating the $300 trillion derivatives market. Gensler stated that Dodd-Frank will "bring sunshine to the opaque swaps markets," which will create more liquidity and competition, and will ultimately lower costs for hedgers, borrowers and their customers. Dodd-Frank rulemaking is expected to take up most of the remainder of the year at the CFTC.

On a related note, CFTC Commissioner Bart Chilton, who is stepping down in June, also spoke this week at the University of Chicago, and described the "swarm of lobbyists" that descend upon the agency incessantly in order to sway the regulators as they write rules to implement Dodd-Frank. According to data that Chilton presented, the financial services industry spent more money on lobbying in 1Q2011 than 1Q2010, suggesting that even more persuasion is being attempted in the implementation rather than the creation of Dodd-Frank. He also spoke about the "advantageous amnesia" that occurs in Washington, D.C., in which politicians have conveniently forgotten about the need to reform the financial system in light of the crisis of 2008, and are trying to repeal Dodd-Frank.

He added "…this crisis was avoidable and another one will be avoidable if we get in gear and get this law implemented."

CFTC COMMISSIONER CALLS FOR TIMELINE TO FINALIZE DODD-FRANK RULES

On May 5, at the Federal Reserve Bank of Chicago's annual conference, Republican CFTC Commissioner Scott O'Malia recommended that the Commission propose a timeline for finalizing Dodd-Frank rulemakings and that it issue an implementation schedule for public comment. O'Malia said "the market needs to know when they will be expected to implement the rules so appropriate investments, staffing and reorganization decisions can be made. Until a final schedule is published, market participants will continue to play a very high stakes game of pin the tail on the donkey." O'Malia's comments echo those of Republicans on Capitol Hill who continue to rail against the pace and scope of CFTC rulemakings.

In addition to calling for a timeline, O'Malia expressed concern that the draft rules do not do enough to address the 'fundamental' character of swaps markets. O'Malia expressed fears that swaps dealers will remain "the prime market makers." O'Malia also feared that the proposed rule on a definition of swap dealer was too broad and just captures "commercial entities that use swaps primarily to hedge their risks." While O'Malia did laud the proposed rules for swap execution facilities he stressed that flexibility must be maintained so that execution facilities may innovate and compete.

FDIC'S CHAIR SHEILA BAIR TO STEP DOWN IN JULY

The announcement that FDIC Chairman Sheila Bair will be stepping down on July 8th, while expected, has sparked a larger discussion on the need to fill key positions across the government's regulatory agencies. Bair will leave the FDIC at the end of a five year term and will likely be replaced by the current Vice Chairman of the agency, Martin Gruenberg.

On Thursday, a central focus of the Senate Banking hearing on Dodd-Frank implantation was the need for strong banking regulators. The Chairman of the committee, Tim Johnson, noted that there are a number of key vacancies—such as the CFPB Director and the insurance advisor for the Financial Stability Oversight Council, and Bair's departure will only add to the list, and there is a growing concern that, absent a recess appointment, the President will not be able to get any nominations to fill these vacancies through the Senate.

DOL "ON TARGET" WITH NEW FIDUCIARY DEFINITION RULE

Assistant Secretary of Labor Phyllis Borzi stated last week that the Department of Labor is "on target" with its plans to finalize the proposed regulation on the definition of "fiduciary." The final rule should be released at the end of the year, and in the meantime the DOL will be fixing some drafting issues to ensure that the rule is "clear and precise," and to reduce the potential for conflicts of interest.

Additionally, Borzi also indicated that the DOL is very close to finalizing its rules revising ERISA Section 408(b)(2), and should be sending the regulation to the OMB in the next few weeks. The interim final regulation was released in July 2010, and would require all companies to disclose all fee information (including hidden fees) if they provide services to employee retirement plans that are regulated by the DOL.

Borzi also spoke about lifetime income streams, and stated that the DOL is continuing to collaborate with the Treasury particularly on issues that came out of the hearings last September. The agencies are both looking at proposals on annuity illustration, and focusing on educating participants on the importance of lifetime income. She noted the need to distinguish between education and advice, which harkens back to the same ideas that are in the fiduciary definition proposal.

Finally, Borzi indicated that she was unsure whether electronic disclosure will be adopted, and the DOL recently put out a notice of inquiry for comments on expanding or modifying the current rules governing the electronic distribution of employee benefit plan information. Concerns exist about delivering electronic information to low-income families, workers without English literacy and disabled individuals, and ensuring that these groups have the appropriate access.

UPCOMING HEARINGS

The House is in recess next week and no major hearings are planned.

On Tuesday, May 17th at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing on the reauthorization of the Export-Import Bank of the United States.

On Wednesday, May 18th at 9:30am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing on "The State of the Securitization Markets."