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FINANCIAL SERVICES LEGISLATIVE AND REGULATORY UPDATE

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As the clock continues to tick down on the U.S.'s deadline for breaching its debt ceiling, President Obama stepped into the fray by publicly reprimanding Republicans for their lack of action on the issue. Meanwhile, with the House out on recess, the Senate stayed busy with hearings on derivatives rules and housing finance reform. Notably, overhaul of the government-sponsored enterprises appears to be significantly stalled as no Senators expressed any enthusiasm for addressing the issue in the near future. In the administration, the Fed set a higher than anticipated cap on debit interchange fees, which sent Visa and MasterCard shares up, but was not high enough to make the banks happy, and the SEC proposed swap transaction business conduct standards intended to "level the playing field." Finally, people continue to watch the mutual fund industry as fears of a potential "breaking the buck" event fester due to the Greek, and European-wide debt crisis. See below for a comprehensive look at these issues and others.

Leading the Week

Treasury confident in August 2nd deadline for debt ceiling breach, economists warn of potential for second recession: Although there has been some conjecture by Republicans (Rep. Michele Bachmann (R-MN) and Sen. Pat Toomey (R-PA), to name a few) that the Treasury's August 2nd deadline for raising the debt ceiling was premature, on Friday the Treasury confirmed this is the date that the U.S. government will deplete its ability to borrow. According to an official statement, "Secretary Geithner urges Congress to avoid the catastrophic economic and market consequences of a default crisis by raising the statutory debt limit in a timely manner." As the deadline looms, and in response to chiding by the President, the Senate canceled its July 4th recess, though it is unclear what the other 97 Senators will accomplish during the upcoming week.

Further, in a direct response to those Republicans who argue that proper prioritization of federal interest payments over other payments could avoid a default, Secretary Geithner sent a letter this week to a group of GOP Senators explaining that the Obama administration has no leeway in this matter. He stated that "this 'prioritization' proposal advocates a radical and irresponsible departure from commitments by presidents of both parties, throughout American history, to honor all of the commitments the nation has made" and "it is unwise, unworkable, unacceptably risky and unfair to the American people. There is no alternative to enactment of a timely increase in the debt limit."

President Obama has also become more involved in negotiations for a deficit-reduction/debt ceiling package. However, it appears that discussions have seemed to have reached a stalemate, as Republicans continue to refuse to discuss revenue increases, leading some to believe that the President's remarks at this week's press conference were intended to better position the President when the country defaults. Obama stated that any deal must be "balanced" and include tax increases in addition to cuts in entitlements and discretionary spending, a statement echoed by Minority Leader Pelosi if Republicans want House Democrats to vote for any proposal. Complicating the politics on this issue, it is becoming apparent that within the GOP, there is dissension among the ranks, and a strong likelihood that House Speaker Boehner will lose upwards of 70-80 Republicans on a debt ceiling vote. A former Hill staffer called this "probably the most whip-proof Congress we've seen in our lifetime," The Atlantic's Joshua Green also noted that there seems to be a three-way struggle between Democrats, Republicans and other Republicans.

According to House Majority Leader Eric Cantor (R-VA, Democrats had agreed to a whopping $2-2.4 trillion in spending cuts over the next decade in "a mix of non-health-care mandatory, health-care mandatory, as well as discretionary savings." Off the record, Democrats familiar with the negotiations denied these numbers, stating that they had only agreed to $1.5-1.6 trillion and cuts, so long as Republicans agreed to $400 billion in tax increases. Obama's statement, along with statements by Minority Leader Pelosi, has made it clear that they intend to extract concessions from the Republicans in order for Democratic votes, meaning that Boehner is going to put in a difficult position, since if he agrees to any tax increases he may lose the support of his conference, a fact that Cantor appears eager to exploit. Meanwhile, as the clock ticks down, an Obama administration official stated on Friday that legislation should be introduced by July 22nd, accounting for the congressional calendar, in order to avoid default.

As we get closer to a potential default, we anticipate a continued increase in warnings from the market and industry researchers, similar to the warnings this past week that if the U.S. government loses its triple-A rating, its bond market stands to lose $100 billion and that a downgrade in rating could also mean increased interest payments (between $2.3-3.75 billion) to finance the U.S.'s annual budget deficit. Although a downgrade is unlikely, this past week, Standard & Poor's decreased its outlook for the U.S. to negative in April (though its rating overall remained constant), and the possibility still exists. Moody's similarly warned that if this were to happen, Fannie Mae, Freddie Mac and other organizations tied to the U.S. government also risk a decreased rating. Economist Mark Zandi is positive about the U.S.'s prospects for economic growth this year, but cautions that if the U.S. fails to raise the debt ceiling by August 2nd, his forecasts would be "blown out of the water," and "even if Congress and the administration reverse themselves days later… we'll probably be thrown into a recession."

Legislative Branch

Senate

Senate Banking Subcommittee meets to examine new Dodd-Frank derivatives rules: In a hearing titled "Emergence of Swap Execution Facilities: A Progress Report" on Wednesday, legislators from both sides of the aisle in the Senate Banking Subcommittee on Securities, Insurance and Investment called on the SEC and CFTC to more effectively reconcile their Dodd-Frank rules related to derivatives. The provision in question at the hearing, which requires standardized swaps to be executed on an exchange or the new "swap execution facilities" (SEF), is being handled differently by the two regulators with jurisdiction. The SEC and CFTC have both proposed rules that would set registration and other requirements for SEFs. Subcommittee Chairman Jack Reed (D-RI) and Sen. Mike Crapo (R-ID) both spoke out on the need for harmonization, and Crapo went so far as to criticize the Act itself for failing to merge the SEC and CFTC. Crapo also stated his preference for the SEC's SEF proposal, which is "in general far less prescriptive than the CFTC proposal," and is more aligned with European proposals.

Senate Banking Committee considers housing finance reform: The full Senate Banking, Housing and Urban Affairs Committee also met on Tuesday to discuss "Housing Finance Reform: Access to the Secondary Market for Small Financial Institutions." Notably, few Senators attended the hearing, and those who did seemed squeamish about enacting any real reforms. Committee Chairman Tim Johnson (D-SD) stated his concern that proposals for the future of the secondary market could lead to bank concentration and unintentionally limit access for small banks, and similarly, Ranking Member Richard Shelby (R-AL) expressed his apprehension about concentration in the mortgage market. About 95% of the mortgage market is reliant on Fannie Mae, Freddie Mac or the Federal Housing Administration, and lawmakers are hesitant to jump into the incredibly complex reform of an already-fragile market. Both Shelby and Johnson were very supportive of protecting the small and community banks from a competitive disadvantage in relation to their large institution competitors. Although the House has moved forward with introducing a variety of bills on this issue, it does not seem likely that anything will move this year.

Senate Democrats Urge House Appropriators to Fund SEC at Appropriate Levels: In response to last weeks party line vote at the House Appropriations Committee for a spending plan that would fund the SEC at 2011 levels - $222 million less than the President's budget request. On June 28th, Senate Democrats sent a letter to the House Appropriations Committee in defense of the SEC's funding request. The Democratic lawmakers—including Senators Reed (D-RI), Menendez (D-NJ), Schumer (D-NY) and Durbin (D-IL)—accused the Committee of shortchanging the agency at a time when "our markets and economy are still struggling to recover." They warned that the failure to provide the SEC with adequate funds will undermine the Dodd-Frank Act, diminish the agency's ability to pursue enforcement activities and limit the SEC's ability to undertake its new responsibilities such as oversight of credit-rating agencies, hedge funds, the OTC derivatives market and private investment advisors.

House Republicans have yet to set a date for the bill to move to the floor. When the spending plan reaches the floor, Democrats will likely offer amendments to boost funding for the SEC and other financial regulators whose budgets would otherwise be slashed. One potential challenge, however, is that House rules would require an offset for these increases to the SEC, and so we do not anticipate any major increases to the SEC's budget coming from the House side.

House of Representatives

No hearings as the House was in a *District Work Period* this past week.

Executive Branch

Federal Reserve

Fed sets higher than expected cap on interchange fees – banks & retailers both unhappy: On Wednesday, the Federal Reserve Board voted 4-1 in favor of a 21-cent debit card transaction fee cap – about double than the 12-cent maximum that was first proposed in 2010. In addition, the Fed delayed the effective date until October 2011. Both the banks and the retailers expressed disappointment in the Feds decision. The new rules will also allow banks to charge an extra .05% of each transaction's value, and will allow the Fed discretion in adding another penny to each transaction. All told, an average debt card transaction ($38) would garner fees of as much as 24 cents.

SEC

SEC unanimously agrees to propose swap transaction business conduct standards: Under Section 764 of the Dodd-Frank Act, the SEC is required to implement business conduct standards for securities-based swap (SBS) entities. On Wednesday, the Commission unanimously voted in favor of proposing new rules that would "level the playing field," according to SEC Chairman Mary Schapiro, by ensuring transparency and the fair treatment of customers. The rules, among other things, would require SBS dealers and major participants to disclose conflicts of interest and material incentives. The proposed rule is available here, and comments are due by August 29th.

SEC officials speak out on floating NAV, Rule 12b-1 and fiduciary duty at industry panel: Last week, money market industry leaders testified before a House Financial Services Subcommittee and urged Congress that a floating net asset value (NAV) would severely impinge on the money market fund industry's ability to serve investors. In response to industry outcry against moving to a floating NAV, at an Insured Retirement Institute (IRI) panel held June 27, the SEC officials announced that it should now be the responsibility of industry to propose a viable alternative for the mutual fund market.

In fall of 2010, the President's Working Group on Financial Markets recommended a number of options to reduce systemic risk in the mutual fund industry, including eliminating the stable NAV of one dollar in favor a floating NAV. The Working Group report also recommended an emergency liquidity facility, NAV buffers and a two-tiered system of stable and floating NAVs in order to avoid liquidity runs. While SEC officials declined to lay out an agency timeline for undertaking the Administration's recommendations. Douglas Scheidt, associate director and chief counsel in the SEC's Division of Investment Management said that there remains "a lot of work" to be done in the money market fund area and the issue is not one that will be "easily resolved."

SEC continues to assess 12b-1, broker-dealer rules: The IRI panel also touched on other high profile SEC rulemakings, including 12b-1 rules and the fiduciary standard for broker-dealers and investment advisers. Scheidt said with the finalization of many of the rules mandated by the Dodd-Frank Act, the SEC will be moving onto other agenda items, including additional "analysis" of the 12b-1 rule which regulates mutual fund distribution fees under the Investment Company Act of 1940. The SEC issued a proposal for reforming the rule in July of 2010 which would cap sales charges, limit fees and improve fee transparency, promote retail price consumption and revise oversight duties of fund directors. Scheidt also discussed the SEC fiduciary duty on broker-dealer and investment advisors. In January, an SEC staff report recommended that the Commission either create a uniform fiduciary standard for all entities that provide investment advice to retail customers, or harmonize existing, differing laws and regulations that pertain to brokers-dealers and advisers. Scheidt said that if the SEC acts on the fiduciary issue this year, it will not likely opt for the harmonization method.

CFTC

CFTC Dodd-Frank study urges creation of a derivatives "dictionary": Over the course of years, financial institutions and countries have all established their own means of defining contracts and data used in derivatives markets. In a recent Dodd-Frank-mandated study by the CFTC, the regulator encouraged the creation of standardized "computer-readable algorithmic descriptions" of derivatives, including the establishment of universal "identifiers" that would allow regulators to understand who is trading in which markets, and eventually this would be contemporaneous with the transactions themselves. CFTC Commissioner Scott O'Malia stated that this would enable the CFTC and other regulators to prevent fraud and market manipulation, but also to measure systemic risk. O'Malia is the head of a CFTC technology advisory committee, established in 2010 with the hopes of studying how the agency can more effectively use technology to regulate high-tech and high-speed markets.

DOL

DOL announces technical changes to seller's exemption, seeks to allay concerns over fiduciary rulemaking: On June 28th, DOL Assistant Secretary Phyllis Borzi announced that the agency will be making changes to the seller's exemption provision of the proposed fiduciary rule due to "drafting issues" raised in public comments. The seller's exemption is intended to amend and expand the definition of fiduciary under Section 3(21)(a) of the Employee Retirement Income Security Act (ERISA). In addition to receiving comments on the seller's exemption, Borzi said there was considerable public comment on the lack of harmonization between DOL and other agencies –like the SEC, CFTC and Treasury—pursuing fiduciary rules. In an effort to assuage these concerns, Borzi said the "rules will be harmonized, and we will not put anybody in a position where compliance under one of these other laws causes a problem for you under ERISA."

International News

Greek Debt Default Seen As Threat to Mutual Funds: Recent reports indicate that there is increasing concern that money market funds will be at risk if Greece defaults on its sovereign debt. With approximately half of money market funds' $1.6 trillion assets invested in the debt of European banks, academics and policy makers are beginning to see a serious weakness in these historically safe investments. While some funds are attempting to play down the risk of heavy investments in government debt, other investors have begun to remove money from the funds.

Last week, Federal Reserve Chairman Bernanke sought to raise confidence in the funds saying, "money market mutual funds don't have much direct exposure to the three peripheral countries which are currently dealing with debt problems." However, Bernanke continued on to say that funds generally have exposure in "so-called core countries: Germany, France, etc. So to the extent that there is indirect impact on the core European banks, that does pose some concern to money market mutual funds." In the same speech, Bernanke said regulators and the mutual fund industry and still working to create reforms to bolster the strength of the industry.

In the wake of the financial crisis, the SEC toughened regulations by slashing the allowable average maturity of debt so that funds can rid themselves of bad loans more quickly. Additionally, the SEC required that 30% of assets must be in cash or highly liquid assets in order to prevent runs. However, much still remains to be done to ensure that funds are protected from runs and loss of liquidity in the event of crisis. Additional regulation may be an uphill battle given the recent mutual fund industry resistance to changes to their market structure in the form of a floating NAV.

Bankers and international regulators agree to extra capital charge for largest banks: In a major success for the U.S. and UK, stakeholders agreed in Basel earlier this week to an extra capital charge of 1-2.5% of risk-adjusted assets for the largest banks. The surcharge is on top of the Basel III minimum of 7% for all banks, set last year, and a smaller percentage was agreed to by regulators in exchange for an all-equity buffer for the banks. The world's eight largest banks: Bank of America, Barclays, BNP Paribas, Citigroup, Deutsche Bank, HSBC, JPMorgan and Royal Bank of Scotland, will be obligated to maintain "core tier one capital" of 9.5% of their risk-weighted assets by 2019, and another 20 or so banks will have to retain 8-9% as well.

The U.S. and UK had been pushing for the world's biggest and most interconnected banks – "global systemically important financial institutions" – to hold on to more capital in order to avoid too much risk. Many policy analysts argue that regulators still have a ways to go in combating systemic risk, and that liquidity, management and operational risk all should play a part in the industry reforms taking place, not just higher capital standards.

Unprecedented exchange merger faces scrutiny in EU: Although antitrust inquiries are common in the case of major business mergers, up to now, exchanges have avoided close inspection. When the New York Stock Exchange acquired Euronext and Nasdaq purchased OMX in recent years, the companies only faced mild inquiries. More recently however, the U.S. Department of Justice denied Nasdaq's joint counterbid for NYSE Euronext with IntercontinentalExchange (which would have combined Nasdaq with the New York Stock Exchange), and the UK Office of Fair Trading referred a proposed acquisition of Chi-X Europe by BATS Global Markets to the European Commission on Competition for further examination. And now, the proposed exchange merger between Germany's Deutsche Börse and the U.S.-based NYSE-Euronext is the largest one every envisaged, and has attracted the watchful eyes of European antitrust regulators.

The European Commission on Competition will be examining this merger in one of two ways – it will either clear the proposal to move forward within 25 business days, or after that 25-day period, it will continue with a more comprehensive investigation over the course of at most 90 business days. Industry analysts believe there is little doubt that the proposed merger will enter the second phase of scrutiny, based on comments by Commissioner for Competition Joaquín Almunia. A decision is expected by the end of 2011.

EU considers tax on financial transactions: In its budget plan released earlier this week, the European Commission proposed expanding its taxing powers to include an EU-wide tax on financial transactions or activity. This is known as a "Tobin tax" after the liberal U.S. economist James Tobin. A fraction of these revenues would go directly to the Commission in Brussels, which EU officials argued would be one way to garner funds for the 2014-2021 budget plan without being entirely dependent on European nations' capital. Other ideas included in the budget proposal were airline ticket taxes, and taking a slice of the EU emissions trading system revenues. The United Kingdom is adamantly opposed to the Tobin tax (particularly because of its sizable financial services industry), and a UK Treasury official was quoted as saying that the concept comes up "occasionally, and it's not going to happen."

UPCOMING HEARINGS

The House of Representatives will be back in session on Wednesday, July 6th, and in lieu of a previously scheduled recess, the Senate will be in session beginning Tuesday, July 5th.

On Thursday, July 7th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on mortgage servicing and foreclosure mitigation.

On Friday, July 8th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on H.R. 1723, which prevents federal bank regulators from arbitrarily penalizing community banks for working with borrowers to modify their loans, and H.R. 2056, which calls for a study on the impact of some FDIC practices and procedures on troubled or failing institutions.

On Tuesday, July 12th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises will hold a mark-up of bills to overhaul and restructure the Government Sponsored Enterprises that are involved in the housing finance market.

On Wednesday, July 13th at 10am, in 2128 Rayburn, the House Financial Services Committee will convene to receive the semiannual Monetary Policy Report to the Congress from Federal Reserve Chairman Ben Bernanke.

On Wednesday, July 13th at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity will hold a hearing on mortgage origination issues.

On Wednesday, July 13th at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity will meet for a hearing on mortgage origination issues.

On Thursday, July 14th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on the rent-to-own industry.

On Thursday, July 14th at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Oversight and Investigations will hold a hearing on the Office of Financial Research and the Financial Stability Oversight Council as data collectors and the potential for data security risks.