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FINANCIAL SERVICES REGULATORY REFORM UPDATE

March 4, 2011

Since the start of the New Year we have seen the Administration engage in a frantic pace of rulemaking in an effort to implement Dodd-Frank in a timely manner. During this time, Congress had, for the most part, deferred action, appearing to need the time in order to get its "sea legs." However, last week confirmed that the Congress has finally found its footing and industry should anticipate another busy year with continued battles on various elements of the Dodd-Frank bill (in both implementation and oversight) and a new front that has opened on the issue of GSE reform.

In terms of the first part of Dodd-Frank that may be ripe for legislative reform, the general consensus is that something will be done, at least in the House of Representatives, on the issue of interchange, a/k/a the "Durbin Amendment." However, because Senator Durbin has made it clear that he does not intend to let any "technical fix" move through the Senate and, as discussed further below, it seems that the Fed is clearly telling members of Congress that their hands are tied, any path forward on an "interchange fix" remains uncertain.

This past week also saw some interesting developments in the Housing sector as Secretary Geithner laid out the Administration's plan for reforming Fannie and Freddie in more detail, while the House Financial Services Committee held a hearing about the effectiveness of the Administrations HAMP program. Chairman Bachus' proposal to eliminate mortgage assistance programs will be on the floor under a rule this coming week, where it is expected to win passage in the House. It is unclear whether the Senate will take up a similar proposal, especially when the Administration is trying to use an estimated $20 billion 50-state settlement for issues related to mortgage servicing to replace the HAMP program.

CHAIRMAN BERNANKE SEES LITTLE ROOM FOR CHANGES TO INTERCHANGE FEE PROPOSAL

On March 1, at a Senate Banking hearing, Chairman Bernanke said that the Fed's proposal on debit interchange fees has little room for the potential changes sought by the community banking industry. Section 1075 of Dodd-Frank directs the Fed to guarantee reasonable fees, wider network access and other changes in the electronic debit sector. Though many smaller banks will be exempt from the rule, there remains concern that costs will still increase.

During the hearing Senator Herb Kohl questioned Bernanke on the interchange issue and on monetary policy, seeking assurances that smaller banks and credit unions will not face pricing and cost pressures. However, Bernanke maintained that Section 1075 leaves little discretion for the Fed to make adjustments to the rule. He said "whether or not there will be any effect on the interchange fees charged by small banks remains to be seen."

The same day, Representative Welch released a letter to Chairman Bernanke, calling for the Fed to move quickly to meet the Dodd-Frank April 22 deadline for a final rule on the Durbin Amendment. Welch stressed that "debit cards are merely electronic checks and should be treated no differently" and that there is no market pressure to keep debit card companies and their member banks in check.

In his letter, Representative Welch asserted that not just a cap, but an elimination of interchange fees would be ideal. He cited paper checks as a system which "has served us all well" by promoting competition in the market place and an appropriate disbursement of costs. He urged the Fed to develop pricing options that would result in "the lowest possible fees." Welch also said that, contrary to comments from the community bank industry, small institutions will gain from the interchange fee cap because it will 'level the playing field."

GENSLER SAYS CFTC WILL NOT PRESS FOR END-USER SWAP MARGINS

In comments on February 28, Chairman Gensler said that the CFTC will follow Congressional intent when designing rules for margins on swaps conducted by commercial end-users. Gensler said that Congress was very specific in their intentions for end-users and they will maintain the ability of end-users and their counterparties to negotiate their own details and clear their transactions. Additionally, Congress was clear that end-users will be exempt from clearing their transactions; end-users remain concerned that the CFTC will require margins in their transactions with their counterparties.

Gensler said the next CFTC rulemaking meeting will be towards the end of March. He did not indicate what would be discussed but did say that the Volcker Rule would not be taken up at that time. Additionally, Gensler commented that the CFTC would not be making the July 15 deadline to finalize rules set by the Dodd-Frank Act. Of concern to the CFTC is the level of funding they will be receiving to enforce the new Dodd-Frank requirements. Despite requests for additional funds by the CFTC and the Obama Administration, House Republicans introduced legislation to cut CFTC funding to 2008 levels.

SENATOR STABENOW URGES CFTC AND SEC TO GO SLOWER IF NECESSARY TO ENSURE THAT RULES "IMPLEMENTED LOGICALLY":

At a hearing on Thursday, new Senate Agriculture Chairman Debbie Stabenow (D-Mich.) spoke to both CFTC Chairman Gary Gensler and SEC Chairman Mary Schapiro at a hearing on Dodd-Frank implementation, said, "I hope you have considered how new rules will fit together in a way that makes sense for the markets—whether that's phasing-in implementation or carefully sequencing the rules."

Although Congress gave the SEC and CFTC just 360 days—until July 15—to finalize the myriad rules required under the financial reform law, the law is less proscriptive, as to when those rules must become effective. In response, Gensler told the committee that the CFTC will not complete its rulemaking by July 15. As of now, the CFTC has proposed 42 rules with a handful to go, although none has been adopted as of yet. Schapiro indicated that the SEC was "working to complete the rulemaking proposal and adoption process [of Dodd-Frank] within Congress' deadlines for implementation." At the same time, she acknowledged that "this is a very challenging task."

During the hearing Stabenow also expressed "some concerns" regarding the degree to which the SEC and CFTC are coordinating their Dodd-Frank efforts, citing in particular the two agencies rules over swap execution facilities, including their concepts of real-time trade reporting, are different. In response, SEC Chairwoman Schapiro acknowledged that there are some differences in the proposed rules, because we have two agencies in largely overlapping spaces. She also noted that, although both commissions are being tasked with regulating derivatives, the securities-based products over which the SEC has jurisdiction represent a smaller, less-liquid part of the market than products the CFTC has under its watch. She then added that the SEC was studying the CFTC proposals—and the feedback that agency was receiving to those proposals—for clues as to what seems to be working and what could be emulated. A point that Gensler echoed, saying the CFTC was working "very closely" with the SEC.

In terms of what may or may not end up being included in the definition of swap dealer, Gensler responded to a question by Senator Klobuchar and her concerns about dairy co-ops being included under a definition by noting that in his opinion much of the co-ops' activities involve forward contracts and options and that he envisioned an upcoming proposal to exclude such contracts from Dodd-Frank requirements.

SEC VOTED TO PROPOSE RULES FOR INCENTIVE-BASED PAY FOR BROKER DEALERS AND INVESTMENT ADVISERS

On March 2, the SEC voted (3-2) to go forward with proposing enhanced disclosure requirements for inventive based broker dealers and investment advisers and to forbid pay structures that lead to "inappropriate" risk practices. The SEC also unanimously agreed to rules to remove credit rating references from the Investment Company Act rules and forms. Chairman Schaprio said "the focus of these efforts is to eliminate over-reliance on credit ratings by both regulators and investors." The SEC also agreed to reopen the comment period for proposed Regulation MC designed to alleviate conflicts of interest in swap markets.

The proposed compensation rule would: require broker-dealers and investment advisers with over $1 billion in assets to disclose their compensation arrangements, forbid arrangements which may lead to risky actions and require firms to develop policies and procedures for such arrangements. The proposal also increases incentive-based pay requirements for smaller entities with more than $50 billion in assets. Two commissioners voted against the proposal calling it ""very particularized" with a "prescriptive regulatory approach." Deputy Director of the SEC's Division of Trading and Markets said they were "sensitive" that deferral of compensation would not be appropriate for all firms.

Comments on the proposed rule will be due 45 days from when the proposal is published in the *Federal Register.*

HOUSE FINANCIAL SERVICES SEEKING TO DO AWAY WITH HOUSING PROGRAMS

On March 3, the House Financial Services Committee approved the FHA Refinance Program Termination Act (H.R. 830) and the Emergency Mortgage Relief Program Termination Act (H.R. 836) which would end the programs that provide housing assistance within HUD. Both bills are scheduled for floor votes on March 7. The committee planned to vote on a third bill (H.R. 839) which would eliminate the Home Affordable Modification Program (HAMP); however, the vote was delayed due to lack of time for consideration. Also postponed was consideration of H.R. 861 which would end the Neighborhood

Stabilization Program. Chairman Bachus swore that the committee would move forward with ending all four programs. Representative Waters and other Democrats argued that HAMP should be maintained as there is no viable alternative program.

SMALL BUSINESS AND FINANCIAL INSTITUTIONS FEAR DODD-FRANK REGULATORY 'TSUNAMI'

On March 2, industry officials testified at the House Financial Services Subcommittee on Financial Institutions and Consumer Credit and expressed significant concerns over the effect of Dodd-Frank regulations on smaller banks, credit unions and business. Of particular concern was the Durbin Amendment which would require caps on interchange fees. Additionally, the industry fears that Dodd-Frank regulations will result in: higher operating and compliance costs, capital limitations, and pricing restraints.

Chairman Kelly of the American Bankers Association called for "quick and bold action to relieve regulatory burdens" which will result in "an appalling contraction of the banking industry, with a thousand banks or more disappearing." The CFPB emerged as a major concern as it is creating uncertainty in the industry. Kelly also expressed concern that the CFPB would increase costs through additional paperwork and reporting requirements. He called for the CFPB to focus its efforts on nonbank financial institutions.

Elizabeth Warren submitted a letter for the record of the hearing seeking to mitigate fears expressed by the industry panelists. She expressed that the CFPB had already tried to work with industry and that the CFPB is knowledgeable of the "deep concern over the future of small financial service providers."

SENATOR SCHUMER ENCOURAGES BERNANKE TO REEXAMINE FSOC DISCRETION ON MERGER LIMITS

On March 1, during the annual Humphrey-Hawkins Federal Reserve hearing, Senator Schumer urged Chairman Bernanke to encourage the FSOC to change bank merger restrictions found in Section 622 of the Dodd-Frank Act. Section 622 established concentration limits which are designed to diffuse risk among financial firms and block any firm from acquiring more than 10 percent of financial sector liabilities. Additionally, Section 622 uses risk-weighted assets crafted the Basel Committee. These limits could block US firms from certain mergers and acquisitions where foreign firms would be allowed to proceed.

It was generally believed that the FSOC did not have discretion to change the concentration limit, which had been set by Congress. However, Senator Schumer maintained that the "FSOC can A) take competitiveness into account and B) that any rules are subject to the recommendations of FSOC." He urged Bernanke to use this discretion.

WARREN SAYS CFPB FOCUS WILL BE ON TRANSPARENCY TO CUT REGULATORY COSTS AND AID CONSUMERS

On March 1, at the Credit Union National Association's Government Affairs Conference, Elizabeth Warren said that the CFPB will focus on transparency and clarity in financial products to ensure that the market works better for consumers and institutions. She said the CFPB's first initiatives will be aimed at reducing regulatory costs through "consolidating the information in the Truth in Lending Act (TILA) and

Real Estate Settlement Procedures Act (RESPA) forms in mortgage origination and creating a smaller, cheaper form that consumers can understand."

Warren stressed that she understands that additional paperwork, disclosures and regulatory requirements will be burdensome and add costs to small institutions. Thus, the CFPB is working hard to "to build a structure and an approach that keeps the new consumer agency in partnership with those who serve consumers."

GEITHNER SAYS CONGRESS SHOULD FINISH MORTGAGE FINANCE OVERHAUL WITHIN TWO YEARS

On March 1, Treasury Secretary Geithner said that the Treasury's housing finance reform plan would take between five and seven years to fully implement. Despite this, Congress should try to craft legislation to overhaul the GSE housing finance sector and the mortgage finance market by the end of 2012 in order to provide a smooth transition to a largely private system. He said that "failing to act would exacerbate market uncertainty and risk leaving many of the flaws in the market that brought" about the crisis in the first place.

The Obama Administration, Congress and the Treasury are beginning a conversation on how to reform Fannie Mae and Freddie Mac. On February 11, the Treasury released a white paper laying out three broad policy options for winding down Fannie and Freddie and reducing the market share of the FHA. All three options dramatically decrease the government's role in the housing sector. The first option would limit federal guarantees to the FHA and the VA. The second option would limit federal guarantees and provide a federal backstop for the market in times of stress. The final option creates a government reinsurance program providing a backstop for private mortgage guarantors.

Chairman Bachus said they have bipartisan agreement on several aspects of the Treasury white paper including: increasing guarantee fees, reducing conforming loan limits, winding down Fannie and Freddie portfolios and requiring higher borrower down payments. Several democratic committee members voiced concern over a shift to private market capital. Representative Watt expressed concern that not "much attention paid to how low-income people can become home owners."

LAWYERS FOR FINANCIAL FIRMS ARGUE FSOC LACKS AUTHORITY TO PROMULGATE SIFI RULE

A February 24 letter submitted on behalf of a number of nonbank financial firms scrutinizes the FSOC's authority to craft rules under Section 113 of the Dodd-Frank Act which addresses how to identify and limit nonbank financial firms which may be systemically significant financial institutions (SIFIs). The letter argues that the FSOC lacks Congressional authority and that the Dodd-Frank Act "contains no express delegation of rulemaking authority to the Council that would support the promulgation of the SIFI Designation Rule."

The letter maintained that even if the FSOC had authority, the current proposed rule is not sufficient and lacks substance and clarity. The lawyers who submitted the letter argued the proposed rule subjects their clients to bank-like regulations. Hedge funds, mutual funds, insurance companies and other non-bank institutions would all be subject to regulation under Section 113.

DOL HEARING ON DEFINITION OF FIDUCIARY

On March 1 and 2nd the DOL held a public hearing on its pending rulemaking to modify the definition of fiduciary under Section 3(21)(A) of the Employee Retirement Income Security Act (ERISA). This is similar to a rulemaking that the SEC is also currently undertaking and which could prove to result in conflicting rules being issued by the Administration.

One issue that generated a lot of attention is whether requiring that certain conflicts of interest involving investment advisers be fully disclosed would be as effective at protecting retirement plans, participants, and beneficiaries as prohibiting those conflicts of interest. During the two days, practitioners speaking on behalf of the financial services industry generally said they favored a disclosure approach to regulating certain potential conflicts of interest. While the Department of Labor attempted to seek practitioners' views on whether the proposed regulation could be improved by expanding the "seller's exemption" from fiduciary responsibility in exchange for comprehensive disclosure requirements along lines proposed by AARP in a comment letter previously submitted to DOL.

Under the AARP's proposal, the seller's exemption would be limited to situations in which investment advice is given to plans and plan fiduciaries and then only to investment advice backed by a statement of the conflict or conflicts of interest inherent in the proposed client-adviser relationship; full disclosure of all sources and amounts of fees or other compensation the investment adviser would receive; plan fiduciaries' clear and unequivocal acknowledgement of the conflicts of interest; and thorough recordkeeping to document the seller's exemption for a reasonable length of time.

Despite questioning practitioners' for their perspective on this proposal, it was clear that the Department had concerns about it serving a substitute for the expanded fiduciary standard, especially with regard to how relatively unsophisticated plan participants might act if they are told about conflicts of interest related to their investment savings for retirement.

Earlier in the week, at the first ERISA Advisory Council meeting of 2011, Phyllis Borzi, assistant secretary of Labor for the Employee Benefits Security Administration, said that EBSA was on track to finalize a proposed fiduciary regulation by the end of the year. The proposed regulation released in October 2010, would expand the circumstances in which a person or entity offering investment advice to an employee benefit plan or plan participants would be a fiduciary under the Employee Retirement Income Security Act.

UPCOMING HEARINGS

The House Appropriations Financial Services and General Government Subcommittee will hold a hearing on proposed fiscal appropriations for the FY2012 at 3pm on Tuesday March 8th and on Thursday March 10th. Please note that the SEC is under the jurisdiction of this committee.

The Senate Budget Committee will hold a hearing on the Commission on Fiscal Responsibility Report on Tuesday March 8th at 10am.

The Senate Banking Committee will hold a hearing on the state of the Housing Market at 2:30pm on Wednesday, March 9th.

House Budget Committee will hold a hearing on the National Debt on Thursday, March 10th at 10am.

The Capital Markets and Government Sponsored Enterprise Subcommittee of the House Financial Services Committee will hold a hearing on the fiscal year 2012 budget request of the Securities and Exchange Commission on Thursday March 10th at 10am.

A joint hearing by two subcommittees of the House Oversight Committee titled: "Financial Management, Work Force and Operations at the SEC: Who's watching the Watchdog" will take place on Thursday March 10th at 1:30pm.

The Capital Markets and Government Sponsored Enterprise Subcommittee of the House Financial Services Committee will hold a hearing on Covered Bonds on Friday, March 11th at 10am.