Jason M. Rosenstock
Direct dial 202 434 7478
JMRosenstock@mlstrategies.com
Cheryl Isaac Aaron
Direct dial 202 434 7400
CIAaron@mlstrategies.com

ML Strategies, LLC
701 Pennsylvania Avenue, N.W.
Washington, D.C. 20004 USA
202 434 7300
202 434 7400 fax
www.mlstrategies.com

FINANCIAL SERVICES REGULATORY REFORM UPDATE

June 24, 2011

LEADING THE WEEK

After a couple of relatively light weeks, driven in large part by the fact that it has seemed like the House and the Senate have rarely been in session at the same time during the past month, this past week saw an explosion of activity.

While the most important, and simultaneously the most fluid story of the past week has been the Biden Deficit Reduction talks and the (depending who you speak to) (a) unanticipated, or (b) expected departure of House Majority Leader Cantor, there certainly was a lot of other newsworthy items that happened which will impact both the financial services industry specifically, but also corporate America generally during this past week.

Earlier in the week, the Senate Banking Committee waded into the ever-increasing problem of corporate cybersecurity and privacy with a hearing that was largely a response to the news that Citigroup had been hacked. This hearing was another in a long line of data security hearings this year, as Congress actively considers how to deal with these complicated issues. There is legislation in both the House and Senate, which, if enacted, could impose new regulatory burdens on businesses not accustomed to dealing with the heavy hand of federal regulation.

Also newsworthy this week was the ever-increasing chorus of Democratic lawmakers calling for the removal of acting OCC Director John Walsh, who are finding significant support for this amongst the liberal blogosphere. Given that the left is currently complaining about Republicans blocking Obama's nominees, it seems incongruous to pressure lawmakers to create yet another vacancy amongst federal regulators.

Finally, the House Financial Services committee had a busy week, not only marking up a handful of bills that would make technical changes to the Dodd-Frank Act, but also holding multiple hearings of interest to industry. One hearing of note was held Friday morning about the mutual fund industry. With many American's relying on mutual funds for their retirement security there could be increased attention on the product – especially if the Greek debt crisis ensnares many of the money market funds that make up a large part of mutual the fund market.

All of these items and more, including the latest news on the CFPB are discussed further below.

CAUTIOUS OPTIMISM REMAINS FOR DEFICIT COMPROMISE DESPITE BREAK DOWN OF BIDEN GROUP

Depending on where you sit, the departure of Eric Cantor from the Biden group-- which put the talks into "abeyance"--- was a brilliant move forced to box Speaker Boehner into a tight negotiating corner between conservative House Republicans who will not tolerate any tax increases, Democrats demanding some type of revenue increase, and the market which appears to grow evermore tired of the political shenanigans associated with the debt ceiling debate. Alternatively, Cantor's move can also be seen as a simple realization that he and the other principles had advanced the ball as far as they were going to take it and it was time to kick the negotiations "upstairs" to the President, the Speaker and Leader Reid to iron out the final details. Either way, Cantor's exit comes after days of reassuring the public that the group was making progress and the talks were on track to conclude in time for legislation to be passed before the July 4th recess.

Although the exit of is being reported as a result of the Democratic insistence that there be new tax revenue collected as part of a deficit reduction package, the Ranking Member of the House Budget Committee, Chris Van Hollen—one of the more candid members of the largely closed lipped Biden Group—attempted to put the blame with Grover Norquist, and Republican fidelity to his "no new taxes pledge."

Adding to the increased pressure on U.S. deficit talks, and giving ammunition to both sides, the Congressional Budget Office (CBO) released a report on Wednesday demonstrating that the national debt could reach almost twice the nation's GDP in 25 years if there are no major changes in spending and revenue. "The explosive path of the federal debt under the alternative fiscal scenario underscores the need for large and rapid policy changes to put the nation on a sustainable fiscal course," according to the CBO report.

Despite the realization that a deal will not be reached before July 4th, the Wall Street Journal reported Friday that the end of the Biden Group could be the beginning of a compromise. The same article reported that a democratic official close to the talks said that the total separating the two negotiating groups was only $1.2 trillion, though that number has been billed as the difference to be bridged for some time now. Congressional and White House officials have been reported as 'optimistic' that higher level talks between the President, Senate Majority Leader Harry Reid and Senator Mitch McConnell slated for Monday will be productive. Speaker Boehner is not participating because his office has indicated that the Speaker is leaving town for the eleven day House recess that starts today and goes until July 6th.

SENATE BANKING COMMITTEE EXPLORES DATA PROTECTION AND CYBERSECURITY IN THE FINANCIAL SECTOR

On June 21st, the Senate Banking Committee held a hearing focusing on the role of cybersecurity and data protection in the financial sector. The Committee heard testimony from financial services industry stakeholders and market representatives on their efforts to combat cyber crime and safeguard consumer data and how the Administration's cybersecurity proposal or Congressional cyber legislation could aid the industry.

While witnesses lauded the Administration's cybersecurity proposals, many stressed to the Committee that industry already has standard best practices to ensure the safety of their customers' data. Panelists stressed that new legislation must look to current best practices and current laws such as Title V of the Gramm-Leach-Bliley Act. In light of the recent breaches at Sony, Epsilon and Citigroup, Senators probed the witnesses on notification practices. In response to a question from Senator Menendez on what the timeframe for customer notification should be, Leah Williams of the Financial Services Roundtable said he believes "as soon as an institution understands what has occurred, they have an obligation to notify their regulators…and they have a fiduciary and a business responsibility to notify customers if there's any way those customers can begin to take action to protect themselves."

Meanwhile, as the US debates the pros and cons of data breach notification this week, across the pond the EU announced that it will be publishing notification rules in the fall. EU Justice Commissioner Viviane Reding said the "robust set of rules" will update the current EU personal data protection system which was established in 1995. The rules will include risk assessments and mandate that entities inform consumers what data has been lost along with advice on what steps to take to avoid identity fraud. To what extent the US will eventually mirror some of the EU rules remains to be seen.

HOUSE FINANCIAL SERVICES SUBCOMMITTEE FOCUSES ON OVERSIGHT OF THE MUTUAL FUND INDUSTRY AND CONCERNS ABOUT EXPOSURE TO EUROPEAN DEBT

On Friday, representatives of the mutual fund industry testified at a House Financial Services hearing. The witnesses included representatives from Vanguard, Fidelity, trade groups and a former regulator who, among other things, sought to convince Representatives that the mutual fund industry is not systemically important.

The witnesses also expressed their concern about the President's Working Group Money Market Fund proposal to move to a floating net asset value (NAV). Scott Goebel, Senior VP at Fidelity said that moving to a floating NAV would "cause shareholders to leave the industry" in favor of less regulated, and more risky, investment options. In lieu of moving to a floating NAV witnesses put forward the idea of a NAV buffer "whereby each money market fund would be required to retain a portion of the fund's income in order to build a buffer within the fund to absorb potential realized or unrealized future losses."

The hearing also showed Congressional concerns about the ongoing process of updating the fiduciary standard going on at the DOL and the SEC. Representative Biggert continued to stake out a public position on this issue by asking the witnesses how DOL and the SEC can harmonize their efforts. Without representatives from either agency at the hearing, it was left to Mercer Bullard, a professor at the University of Mississippi, who indicated that while it was clear that that the fiduciary standard must be updated, it was equally transparent that respective agencies disagree on how to harmonize their efforts with the SEC is focusing on public enforcement mechanisms while DOL is looking to liability issues.

The plethora of regulatory actions at the SEC and DOL related to potential fiduciary engagement is a point of contention for many in the retirement industry. See below for more on this issue.

SENIOR DEMOCRATS CALL FOR REPLACEMENT OF ACTING HEAD OF OCC

The acting comptroller of the currency, John Walsh, made a statement earlier this week that "we are in danger of trying to squeeze too much risk and complexity out of banking as we institute reforms" and pushed for more time to examine the consequences of new regulations and liquidity rules. He added that "capital levels are now extraordinarily high by historical standards" and establishing global capital standards for banks may need a "fundamental re-think."

These remarks appear to have been the last straw for several members of Congress, including Sen. Carl Levin (D-MI), Sen. Jack Reed (D-RI), Rep. Barney Frank (D-MA) and Sen. Sherrod Brown all of whom have called for the Administration to replace Walsh this week. As it typical, Levin's response was particularly adamant, saying that Walsh's statement "continued the OCC's unfortunate history of removing important regulatory protections." However, Senator Reed, a senior member of the Senate Banking Committee, also stated that the Obama administration should "fundamentally re-think the OCC's leadership and ensure that American taxpayers are never again on the hook for Wall Street's misdeeds" and "Mr. Walsh's latest comments provide further evidence that he is not interested in leading an agency charged with ensuring the safety and soundness of our financial institutions." Thursday, Sen. Brown sent a letter to Secretary Geithner calling for the swift removal of Walsh on the grounds that his opposition to stronger capital requirements is "deeply flawed" and a threat to the US financial system.

Friday, a White House official said that the President will announce a nominee to replace Walsh "soon." While officials did not give any indication as to who the President is considering to head the OCC, it is rumored that the Administration is considering Thomas Curry, a member of the FDIC Board.

REPUBLICANS CONTINUE TO HAUL FINANCIAL REGULATORS BEFORE HOUSE COMMITTEES

On Wednesday, FDIC Chairman Sheila Bair testified before the House Oversight and Government Reform Subcommittee on Financial Services. Unlike her counterpart at the OCC, Bair spoke out strongly in favor of robust capital buffers, and was questioned by Chairman Patrick McHenry (R-NC) why there is a discrepancy between her and Acting Comptroller John Walsh's opinions. Bair responded that "strong capital is a competitive strength, not a competitive weakness," and went on to explain that the sovereign debt crises in Europe is "related to the high levels of leverage in their banking system… So I worry about capital levels in Europe, and I worry about some of that coming back to the United States." Bair also endorsed Dodd-Frank's risk retention requirements, and applying the 5% requirement across the board, without exception.

McHenry also asked Bair about small bankers' complaints that they are unable to lend as much as they would like because of the FDIC's stringent standards. Bair responded that the federal government established a $30 billion Small Business Lending Fund (SBLF), created in the Small Business Jobs Act of 2010, that was intended to cultivate economic growth, and her agency has instructed examiners to allow sensible loans to move forward.

Treasury Secretary Geithner also discussed the SBLF this week when he testified Wednesday in front of the House Small Business Committee. Ranking Member Nydia Velazquez (D-NY) pointed out that only 847 of the U.S.'s 9,000 banks applied for funding, and asked Geithner why this was the case: "if liquidity was a problem, there would have been a line out the door for SBLF funds." Geithner, the first Treasury Secretary to ever testify before this Committee, responded that eligibility for these funds was limited to banks with assets less than $10 billion, and thus relatively few banks could be expected to apply. He "expect[s] to begin providing capital very soon," and although he received some pushback from Committee members on this timeline, he added that the SBLF will still live up to its intended potential.

HOUSE COMMITTEE APPROVES LEGISLATION TO MITIGATE DODD-FRANK -- CREATE U.S. MARKET FOR COVERED BONDS

At a legislative mark-up session in the House Financial Services Committee on Wednesday, several bills aimed at scaling back the Dodd-Frank Act were voted favorably out of the Committee. One of the bills, H.R. 1070, would exempt companies that manage up to $50 million in securities for public offering from registering with the SEC. Currently, this exemption is $5 million, and the bill's sponsor, Rep. Dan Schweikert (R-AZ) stated that the limit should reflect the increased costs of bringing a small company public. An amendment offered by Rep. Gary Ackerman (D-NY) was also approved, and this would require securities issuers to file audited financial statements annually.

Another bill passed out of Committee, H.R. 1082, would exempt most private equity fund raisers from having to register with the SEC, thereby directly overturning a Dodd-Frank provision. The bill's sponsor, Rep. Robert Hurt (R-VA), stated that "private equity funds did not cause the financial crisis" and he aimed to level the playing field for equity fund advisers with venture capitalists, who are exempt from registration. Rep. Nan Hayworth's (R-NY) H.R. 1062 had a successful vote, and would repeal a provision in current law requiring publicly traded companies to disclose their employees' median compensation packages separately from the CEO packages.

Additionally, the Committee took up H.R. 940, introduced by Scott Garrett (R-NJ) and easily passed the measure by a vote of 44-7. This legislation would create the legal framework for a U.S. covered bond market. The bill's language is similar to provisions considered during debate on Dodd-Frank, but which never made it into the final version of the law. Garrett's hope is that covered bonds will be another outlet for credit in the housing finance market, but not a replacement for existing credit options. He opposed the originate-and-distribute model of securitization in favor of keeping covered bonds on the balance sheets of the financial institutions that originate them, which will in theory create incentives for sensible underwriting and greater transparency and liquidity. Garrett's amendment to limit issuances of covered bonds to non-banks that are supervised by the Federal Reserve was also approved.

Despite the apparent widespread and bipartisan support for Garret's measure, the FDIC continues to express significant concerns about the measure and its impact on the deposit insurance fund (DIF). Interestingly, two amendments by Rep. Barney Frank were rejected by the Committee, which would have given the FDIC oversight authority and the ability to take action in cases of covered bond issuers going into default, liquidation or bankruptcy.

Following passage of the measure, an FDIC spokesman said, "not only does the legislation subsidize covered bond investors with the DIF…it will add to the funding advantage that large institutions already enjoy." Even supporters of a covered bond industry admit that the legislation leaves room for banks that issue covered bonds to use federally insured money to pay off entities that have invested in defaulted bonds, though argue that the chances of this situation arising are slight and the benefits of this new market far exceed the risks of taxpayer exposure. Despite the rumored backing of Senators Charles Schumer (D-NY) and Bob Corker (R-NY), additional changes will likely have to occur before this measure can clear the Senate.

HOUSE FINANCIAL SERVICES APPROPRIATIONS BILL DECIMATES CFPB FUNDING; CUTS SEC FUNDING LESS THAN EXPECTED

On June 23, the House Appropriations Committee approved a financial services appropriations bill by a party line vote of 27-21. Among other things, the bill would limit the amount of funds that the CFPB could receive from the Fed to $200 million. The bill also places the consumer agency's budget under the Congressional appropriations process beginning in FY2013 as part of a Republican effort to exert greater control over the Bureau. Ed Mierzwinski, the Consumer Program Director at US Public Interest Research Group accused the House Appropriations Committee of curtailing the agency's independence and crippling "the agency's ability to protect Americans from financial industry tricks and traps."

Additionally, the bill funds the SEC for FY2012 at the FY 2011 levels of $1.185 billion-- $222 million less than the Administration requested in the President's Budget, but significantly more than the draconian cuts initially feared. However, the Committee didn't just write a blank check. The bill includes a provision that prohibits funding to the Commission's reserve fund, viewed by some as a "slush fund" for the SEC for programs that have not been approved by Congress. These cuts follow last week's party line House vote of 217-203 to slash the CFTC's budget by 15%.

Although it comes as no surprise, Senate Minority Leader Mitch McConnell (R-KY) spoke out earlier this week about his support for blocking funding increases to the key Dodd-Frank regulatory agencies – the SEC and CFTC. He stated, "the less we fund those agencies the better America will be. I think anything we can do to slow down, deter or impede their ability to engage in this oppressive overregulation, which is freezing up our economy, would be good for our country." In response, SEC and CFTC officials stated that they are already being stymied in carrying out their duties because of restrictions on spending. Travel for enforcement operations and new hiring have greatly abated as the agencies await their fiscal appropriations.

House Financial Services Committee Ranking Member Barney Frank (D-MA) also stated that McConnell's remarks make "it very clear that the reduction in funding has zero to do with the deficit. If we had a surplus [the GOP] would still be under-funding these agencies. They've torn the fig leaf of debt reduction off the naked ideology that they've been pursuing."

While both the CFTC and SEC did not win big in the Congressional budget process, and clearly have an uphill battle ahead of them to keep the funding they are receiving—the heads of both agencies are moving forward with their regulatory agendas. At the Wall Street Journal CFO Network Conference June 21, both Chairmen Gensler and Schapiro discussed their priorities for the coming months. Gensler said that the CFTC will be focusing on finalizing the swaps rules that the agency recently delayed implementation on until December 31. In addition to implementing Dodd-Frank, Schapiro also said that the SEC will soon address reverse mergers.

CFPB SEEKING PUBLIC COMMENT ON CRITERIA TO SUBJECT NONBANK ENTITIES TO INCREASED SCUTINY

Despite the defeat it suffered in the appropriations subcommittee, the CFPB continues to press ahead with its agenda and by all indications will be going "live" on July 21st. That is why, on the same day that House appropriators were cutting its funding, the Bureau announced that it was seeking public comment on the six varieties of non-bank financial services companies that could be subject to examinations and other aspects of bank-like supervision. The Dodd-Frank Act directs the Bureau to look at nonbank mortgage companies, payday lenders, private education lenders and other, "larger participants" in the nonbank sector that merit increased regulatory scrutiny, and all were identified by the CFPB as ideal for subsequent regulation. Potentially giving the CFPB cover in this exercise was the Financial Services Roundtable, who indicated that they support the measure. Of course, this should not be surprising given that the FSR's member companies could benefit from the increased regulatory costs the CFPB could impose on these heretofore, unregulated competitors.

Currently, the CFPB is collecting public comment on whether the "larger participants" should include entities such as debt collectors, consumer reporting agencies, consumer credit providers, money transmitters, check cashing entities, prepaid card issuers and debt relief programs. The CFPB is also asking for public comment on what criteria the Bureau should use to designate "larger participants." The Bureau has said that possible criteria include the frequency and value of yearly transactions, asset size, yearly revenue and total loan amounts. The CFPB is also looking for guidance on how long identified entities should be subjected to the increased regulatory scrutiny.

Despite the CFPB's efforts to begin to develop these standards, the Bureau is not allowed to regulate the nonbank sector until a Director for the agency is confirmed by the Senate. It does not appear likely that a Director will be confirmed, much less nominated, by the 21st of July.

SEC APPROVES FINRA REGULATION REQUIRING BROKER DEALER STAFF TO REGISTER

Last week the SEC approved a proposed rule that would alter FINRA Rule 1230(b)(6) to subject broker-dealer back office employees to the same registration and qualification examination standards as front office personnel. The rule also imposes continuing education requirements on covered personnel. In a statement, the SEC commented, "given the growing complexity of the industry, and the importance of the services provided by the back-office personnel" the rule will be helpful in addressing "regulatory gaps."

The rule changes apply to three types of personnel within broker-dealer firms including senior management responsible for covered functions; those responsible for approving or authorizing work for covered functions; and those with authority to make contracts and agreements or commit capital in pursuit of covered functions. There are sixteen items which are considered covered functions by the rule including the collection and distribution of funds, account transfers, financial control through ledger or treasurer responsibilities, preparing or filing financial regulatory reports and entering into books and records.

The SEC designated that the proposed rule be considered on an accelerated timeline because the changes are needed to avoid fraud and to protect investors. The Commission is allowing 21 days for public comment on the rule change.

NCUA FILES SUIT AGAINST BANKS TO RECOVER LOSSES RELATED TO MBS

This week, the National Credit Union Administration filed suit against JP Morgan Chase and the Royal Bank of Scotland to recover billions in losses incurred when the agency seized the failing wholesale credit unions during the financial crisis. NCUA claims that the banks made "numerous material misrepresentations" of their mortgage-backed securities resulting in the belief that "the risk of loss associated with investment was minimal, when in fact the risk was substantial."

While the two financial institutions declined to comment, Debbie Matz, Chairman of the NCUA, was vocal in her support of the agency's actions. Matz said the agency's legal actions are part of an ongoing effort to hold entities responsible for selling bad securities. She said "the first two actions involve damages in excess of $800 million" and the NCUA expects "to file additional actions and seek a total amount of damages in the billions of dollars."

On the heels of NCUA's action, JP Morgan Securities had decided to settle – for $153.6 million – a suit filed against it by the Securities and Exchange Commission over bad bundles of mortgage-backed securities, and the firm Morgan Keegan also announced it would pay $200 million in a settlement with the SEC and state regulators. These follow a $550 million dollar settlement last year by Goldman Sachs in response to an allegation by the SEC charging Goldman Sachs with fraud related to the financial institution's MBSs. Perhaps these latest cases are the proverbial "blood in the water" for the feeding frenzy of state and federal regulators.

EU DERIVATIVE PROPOSAL STALLED DUE TO CONFLICTS OVER SCOPE OF REGULATIONS

Recently, conflict has emerged among EU member states and the EU parliament over several aspects of the European regulatory framework for derivatives. The primary areas of conflict include the scope of the new regulatory regime, the role of the newly created European Securities and Market Authority (ESMA) in regulating central clearing parties, clearing exemptions for pensions and centralized clearing party access to central bank liquidity. The next meeting of the EU finance ministers is slated for July 20th, where Poland—the next country to take up the rotating EU presidency—hopes to make progress in the regulation of derivatives.

UPCOMING HEARINGS

The House of Representatives will be in recess during the week of June 27th, and back in session on Wednesday, July 5th.

On Tuesday, June 28th at 10am, in 215 Dirksen, the Senate Finance Committee will hold a hearing titled "Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due."

On Tuesday, June 28th at 10am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Committee will hold a hearing titled "Housing Finance Reform: Access to the Secondary Market for Small Financial Institutions."

On Wednesday, June 29th at 9:30am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance and Investment will hold a hearing titled "Emergence of Swap Execution Facilities: A Progress Report."

On Wednesday, June 29th at a time TBD, at the National Computer Forensics Institute in Hoover, AL, the House Financial Services Committee will hold a field hearing on the threat that cybercriminals pose to individuals and financial institutions.

On Wednesday, June 29th at 2pm, in Dirksen 538, the Senate Banking Subcommittee on Housing, Transportation and Community Development will hold a hearing titled "Promoting Broader Access to Public Transportation for America's Older Adults and People with Disabilities."

On Thursday, June 30th at 10am, in 215 Dirksen, the Senate Finance Committee will hold a hearing titled "Perspectives on Deficit Reduction: A Review of Key Issues."

On Thursday, June 30th at 2pm, in Dirksen 538, the Senate Banking Committee will hold a hearing titled "The State of the FDIC: Deposit Insurance, Consumer Protection and Financial Stability."

On Thursday June 30th, at 10am, in 538 Dirksen, the Senate Banking Subcommittee on Security and International Trade and Finance will hold a hearing titles "Stakeholder Perspectives on Reauthorization of the Export-Import Bank of the United States."

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 reform the Government Sponsored Enterprises.

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 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.