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FINANCIAL SERVICES REGULATORY REFORM UPDATE

For the Week of April 12, 2010

REID ACCELERATES TIMELINE FOR CONSIDERATION - REGULATORY REFORM LIKELY TO BE ON THE FLOOR NEXT WEEK:

Despite the fact that the Administration continued to use its bully pulpit during this past week to highlight the need for what it is calling "Wall Street Regulatory Reform" many on Capitol Hill and K Street were surprised when Senate Majority Leader Reid announced late in the week that he plans on bringing the Senate passed version of the bill to the floor next week. Although no one had an idea as to when the bill was going to be the floor, the conventional wisdom appeared to be that it was more likely that consideration would slip a week backwards, not forward, from the rumored April 26th start date. Whether this accelerated timeline was simply a negotiating tactic or if the bill will actually be on the floor of the Senate next week remains to be seen. In trying to read the tea leaves it is worth noting that Leader Reid only filed cloture on pending nominations and not for the reg reform bill.

GOP INCREASES IT RHETORICAL ATTACKS AGAINST REG REFORM

Although it initially appeared that as many as eight Republicans could side with Democrats on Reg Reform, by the end of the week, Minority Leader McConnell had successfully persuaded all 41 of his Republican colleagues to sign a letter stating their opposition to moving a "partisan bill." However, even in light of the Republicans' letter, some Democrats remain optimistic that a bipartisan bill is possible, and some Senate Democrats also continue to believe that Republican opposition will not last as it will be too politically painful to be seen as supporting Wall Street. As commentators have noted, this debate has become a "political high-wire act," in which Republicans are seeking to obstruct the Democrats' bill without appearing to side with Wall Street banks.

In terms of policy arguments, Senate Republicans appeared to coalesce around criticism that Dodd's bill would "allow endless taxpayer-funded bailouts." The White House and Democrats responded by accusing Republicans of siding with Wall Street, and lobbyists, whereas Democrats are on the side of American families. Republicans were particularly concerned with a provision that would create a $50 billion fund to take over at-risk firms whose collapse would threaten financial markets. Under this provision, large financial companies, and not taxpayers, would pay an assessment to create the fund to handle the dismantling of systemically risky financial firms. However, when pressed on this issue, Treasury Secretary Geithner seemed to indicate that it was not a critical component of the legislation.

OTHER CONCERNS:

As this battle winds towards the final stretch, other concerns about the bill are being brought forward. For example, the North American Securities Administrators Association expressed doubt that the reg reform bills currently under consideration in Congress will actually prevent future economic crises. The president of the organization, Denise Crawford, opined that harmonization - of the discrepant standards between investment advisers and broker-dealers - is the most important change that Congress can accomplish for main street investors. Both chambers of Congress have been more focused on issues of systemic risk regulation and consumer protection.

Meanwhile, the director of the SEC's Division of Investment Management expressed concerns about his agency ability to handle the additional workload that will be created by the change in federal registration requirements contained within the legislation. Both the House and Senate bills would increase the threshold over which investment advisers are required to register with the SEC - from $25 million to $100 million in assets under management. In other words, all investment managers in the mid-range of $25 million to $99.9 million, about 4,000 advisers, would fall under state jurisdiction.

Additionally, the Consumer Finance Protection Entity, known as the CFPB in the Senate bill, but still generally referred to as the CFPA, continues to be a point of contention between opposite sides of the aisle. Liberal democrats, such as Senators Franker, Boxer and Sanders, are joining in an effort to strengthen CFPA provisions, and keep it as an independent entity outside the Fed. Republicans, financial firms and the U.S. Chamber of Commerce continue to argue that a new agency would just add a new layer of bureaucracy for businesses, add costs to consumers and restrict access to credit for small businesses. Up to this point, the Chamber of Commerce has led a $3 million campaign against the CFPA provision, and House Republicans fought for a sunset provision on all bank regulatory agencies. Now, there are signs that Republicans could be willing to compromise, as Sen. Shelby proposed the idea last week of creating an independent CFPA in exchange for making Republican changes in other parts of the legislation. However, it is important to note, that it appears that decisions of Shelby's independent CFPA could be overridden by an outside commission.

LINCOLN CHANGES COURSE ON DERIVATIVES REGULATION

In addition to attacking the resolution fund, the issue of how the bill will deal with the regulation of the derivatives market is also very controversial. Dodd's draft had a section on this issue, but it was generally seen as a place holder for legislation that Senator Blanche Lincoln, Chairwoman of the House Agriculture Committee would introduce. Late on Friday afternoon, Sen. Lincoln unveiled her derivatives proposal, "The Wall Street Transparency and Accountability Act of 2010." The bill, which will be marked-up in committee next week, would create drastic changes for a handful or large banks that control 97% of the OTC derivatives market, though it is rumored that there will be efforts to amend it before it is finally merged with the reg reform bill, with a serious effort likely to occur to delegate the controversial end-users exemption to the CFTC. As it is written now, the bill would prohibit the Fed and FDIC from providing any federal funds to ball out Wall Street firms who engage in risky derivative deals. The bill would also give regulators broad enforcement authority to punish bad actors that knowingly defraud third parties or the public, and would create a fiduciary duty for swap dealers (just like investment advisers). Derivatives transactions would have to be cleared, at the discretion of a regulator, and would be required to be traded on a regulated exchange. Regulators would also be given the authority to close any subsequent loopholes they discover.

Up to this point, Senate Agriculture Chairwoman Blanche Lincoln had been criticized for giving up too much with regard to the over-the-counter (OTC) derivatives market. It was rumored that Lincoln had reached an agreement with her counterpart, Ranking Member Saxby Chambliss, but that the White House, Treasury Secretary Geithner and CFTC Chairman Gary Gensler purportedly stepped in to prevent the deal.

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS GRILLS OFFICE OF THRIFT SUPERVISION DURING HEARING ON WASHINGTON MUTUAL'S (WAMU'S) FAILURE:

The Senate Homeland Security and Government Affairs Permanent Subcommittee on Investigations met on Tuesday to question Washington Mutual's Kerry Killinger, its former CEO, and discuss the Subcommittee's 18-month investigation into the bank. WAMU is the biggest U.S. bank to ever fail, and Killinger defended the bank's actions in a highly-confrontational and finger-pointing hearing. The Subcommittee's investigation found that the Office of Thrift Supervision (OTS) had identified a pattern of errors, poor risk management, and even fraud at the bank, and yet it took no action to stop WAMU from dumping toxic mortgages into the financial system. OTS director John Reich defended his agency's actions, arguing that the fact that OTS received 15% of its budget from WAMU fees had nothing to do with its soft treatment of the bank. Senator Carl Levin, chair of the Subcommittee, said that the OTS was a "watchdog with no bite," and that it failed to keep an arm's-length relationship with a bank it was supposed to be regulating.

Additionally, the panel heavily criticized Reich for being unaware that 90% of the bank's home equity loans were no- or low-documentation mortgages. Levin particularly lambasted Reich for collaborating with WAMU, even after years of red flags about the bank's exotic mortgages, calling it "pitiful enforcement." OTS Inspector General Eric Thorson conceded that examiners didn't follow OTS guidelines because "WAMU was making money and its loans were performing," and also argued that its ability to regulate WAMU was hampered by infighting between the agencies. A disagreement with the FDIC over OTS's financial soundness ratings of WAMU in 2008 was only resolved one week before the bank's collapse.

Sen. Levin said that the panel won't decide until after this week whether to refer the WAMU case to the Justice Department for possible criminal prosecution. However, the timing of this hearing and the scathing criticism of OTS that came from it, it would appear that the future of OTS is quite tenuous.

SEC CHARGES GOLDMAN SACHS ON CDO TRANSACTIONS

On Friday, just hours before Sen. Lincoln introduced her derivatives bill, the SEC charged Goldman Sachs with civil fraud, accusing the bank of intentionally designing a financial product that would have a high chance of falling in value, at the request of a client, and lying to the customers who bought it. The SEC said that Goldman allowed the client to pick bonds he wanted to bet against, and then packaged those bonds into a new investment. These bonds were sold to other customers, and later 83% of them were downgraded by rating agencies. Industry insiders are keeping a close watch on the case, because when decided, it could also create some clarity on whether malfeasance played a role in the financial meltdown (and not just greed, incompetence and weak regulation). Goldman Sachs denies all the accusations, and up to now, the bank and other key players on Wall Street have treated the financial crisis as an "act of God."

Republicans and Democrats used this case as an opportunity to heat up the reg reform debate. House Republican Leader John Boehner stated that Goldman Sachs would benefit from a perpetual safety net that the Dodd bill would create, while Dodd stated that this case demonstrates the need for new legislation.

BONUS DEPRECIATION INCENTIVE EXTENSION

On Thursday, Peter Orszag, the director of the White House Office of Management and Budget, and one of President Obama's top economic advisers, urged Congress to renew the bonus depreciation investment incentive through 2010, as a way to help boost economic activity. The tax incentive allows businesses to expense up to 50 percent of the cost of business equipment in the first year of its purchase, rather than following the IRS's less generous depreciation schedule. Initially the provision was included in the 2009 stimulus plan, and was eventually dropped from this year's stimulus plan. Some economists, from the Fed and Treasury Department, questioned the effectiveness of the tax incentives as it was used in past years. Orszag, in an address to the National Association of Manufacturers, stated that the bonus depreciation would spur investment in capital and continue the country's economic recovery.

THE EU RESPONDS TO AMERICAN REG REFORM

The Obama administration and international hedge fund community have expressed concern about a potential new "protectionist" regime proposed by the European Union's lead negotiator. As a means of "leveling the global playing field," this proposed legislation would create a classification scheme for international hedge funds that would affect the extent to which EU investors could invest in them. In the first category, those countries with an adequate regulatory scheme would sign a treaty with an EU supervisory committee, and funds in these countries would receive an EU-wide passport to operate. In the second category, countries lacking some regulatory safeguards or having inadequate enforcement would not gain the benefits of an EU-wide passport, but rather would be subject to each EU country's individual standards. Parliament Member Jean-Paul Gauzes believed that would include countries such as the Cayman Islands, where many U.S. and UK managers base their funds. The final category would essentially be a "black list" - European money would be prohibited from investment with fund managers in countries with few regulations and no enforcement.

This proposal comes in advance of an April 27th vote due to take place in the European Parliament's Committee for Economics and Monetary Affairs. It also comes on the heels of a period of intensive lobbying by U.S. Treasury Secretary Geithner, who sent numerous letters to EU finance ministers expressing his hope that "non-EU funds, fund managers and global custodians [have] the same access as their EU counterparts and [they would] promote a single market." This proposal would additionally need to pass the Council of Economic and Finance Ministers, and the European Parliament General Assembly, before it would become law.

SUPREME COURT'S RECENT CAMPAIGN FINANCE POTENTIALLY DRIVING CHANGES TO CORPORATE GOVERNANCE RULES

The recent Supreme Court *Citizens United*, which would allow corporations to spend unlimited and unregulated sums on political advertising, has lead both the White House and leading Democrats to propose new legislation that, among other things would force private companies and groups to disclose financial contributions to campaigns and advertising. President Obama has outwardly opposed the Supreme Court's January decision, which held that the government cannot ban private organizations from spending in political campaigns. Senator Schumer and Representative Van Hollen are leading efforts in the Senate and House, respectively, and are expected to announce details of their plan as early as next week. They are working to secure Republican support in each chamber, but plan on moving forward whether or not the legislation is bipartisan. Democrats see this as an opportunity to portray themselves in opposition to Wall Street and corporate money in politics.

However, it would seem that the language of the Supreme Court decision does not allow much room for a ban on corporate campaign financing altogether. Instead, legislators are focusing on transparency requirements as a means of discouraging excessive corporate involvement. For example, the Democrats' proposal would require private organizations to identify all their financial donors or set up separate accounts within the organizations to handle political spending. The proposal would also ban political expenditure by some government contractors, companies that received bailout money from the Troubled Asset Relief Program, and companies that have more than 20 percent foreign ownership.

Some Republicans have endorsed more disclosure as a key to campaign finance overhaul, but it is unclear whether any would be fully on board with the Democrats' plan. Rep. Van Hollen added that stakes are high to get the bill passed before midterm campaigns are underway. As a result of the *Citizens United* decision, millions and millions of corporate dollars could be funneled into upcoming campaigns through dummy and front corporations, if no legislation action is taken.

NEW PROXY AND CORPORATE GOVERNANCE RULES

In addition to introducing legislation to limit the influence of corporations in political advertising, both the Administration and House Democrats are using the *Citizens United* decision as justification to examine proxy access and corporate governance rules.

This week, the director of the SEC Division of Corporation Finance Meredith Cross said that her staff is "hard at work" in finalizing a recommendation for a new proxy access rule. She wouldn't go into details about the controversial rule, but an SEC proposal would amend federal proxy rules to facilitate the rights of shareholders under state law to nominate corporate directors. SEC Chairman Mary Schapiro promised to consider this proposal early in 2010, but it looks like it may not be finalized until May or June. When released, the rule will likely be subject to legal challenge by the business community.

Cross is also working on a concept release of proxy mechanics, which she promised would be completed soon (and offered no more detail on timing). In this release, the SEC will solicit public comments on issues such as the distinction between non-objecting beneficial owners (NOBO's) and objecting beneficial owners (OBO's) and whether this should be retained; the role of proxy advisory firms, and whether the low voting rate of retail investors can be improved. Additionally, Cross plans to assess her staff's approach to shareholder proposals on the topic of political contributions in light of the *Citizens United* decision, before deciding if improvements may be implemented for next year.

And late last week, House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Chairman Kanjorski announced that his subcommittee would be holding a hearing next week to examine whether there needs to be additional rules to expand shareholder powers in light of the *Citizens* ruling.

UPCOMING HEARINGS

On Tuesday, April 20th at 11am, in 2128 Rayburn, the House Committee on Financial Services will hold a hearing on "Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner.

On Wednesday, April 21st at 10am, in 2128 Rayburn, the House Committee on Financial Services' Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises will hold a hearing on "Corporate Governance and Shareholder Empowerment."

On Thursday, April 22nd at 10:30am, in 1300 Longworth, the House Committee on Agriculture Subcommittee on General Farm Commodities and Risk Management will hold a public hearing to review proposals to establish exchanges trading "movies futures."