ML
STRATEGIES

Jason M. Rosenstock
Direct dial 202 434 7478
JMRosenstock@mlstrategies.com

Abby Matousek
Direct dial 202 434 7329
AMatousek@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

Follow us on Twitter @MLSFinRegUpdate

FINANCIAL SERVICES LEGISLATIVE AND REGULATORY UPDATE

September 24, 2012

Leading the Past Week

As quick as members returned from their districts, it seems they've left again, as the Senate passed the continuing resolution (CR) measure to fund the government for an additional six months. The Senate vote on the CR was delayed by timing problems of the vote and a move by Senator Rand Paul (R-KY) to cut foreign aid to Libya, Egypt and Pakistan. When Congress returns on November 12th it will certainly have a lot to deal with as the nearly year long practice of punting difficult issue until the lame duck will come home to roost. From the farm bill, to the defense authorization, to countless other legislative initiatives including how to deal with the expiring tax cuts and sequestration, the lame duck is quickly shaping up to potentially be one of the busiest in memory. Also worth noting from this past week was Congress' first major foray into examining issues related to high frequency trading, as well as hearings that will set the stage for future work on capital gains and pension reform. It also emerged this week that the Permanent Subcommittee on Investigations intends to use the JPMorgan trading loss to push for a tighter implementation of the Volcker Rule.

Fiscal Cliff

With both bodies punting the heavy legislative work until after the election, the past week saw a continuation of the public posturing on the looming issue of the fiscal cliff. Senate Majority Leader Harry Reid (D-NV) said he expects that after the November 6th election, Congress will be successful in avoiding the fiscal cliff. Senator Richard Durbin (D-IL) echoed Reid's statement, saying the partisan divide will lessen following the election. While Reid and Durbin may be optimistic, some Republicans believe the party divide cannot be bridged—regardless of the outcome of the election. House Speaker John Boehner (R-OH) has said he is "not confident at all" Congress can reach a deal to avoid the spending cuts and tax increases. Similarly, a former advisor to Senator Jon Kyl said "you get back to the same old issue that we haven't been able to bridge the gap, that has prevented agreement."

Congress is hoping to avert the impact to the economy from the combination of $1.2 trillion in automatic spending cuts that will begin in January as part of sequestration and the expiration of the Bush-era and other tax provisions. The CBO estimates that the fiscal changes scheduled to take place at the end of the year amount to $607 billion in tax increases and spending reductions for just 2013. One of the expiring tax provisions is the alternative minimum tax (AMT) patch, which, should it expire, will affect the 2012 tax filing season. Additionally, contention has arisen over Democratic proposals to let tax Bush-era cuts expire for top earners—something Republicans, who want to extend all the cuts in favor of additional spending reductions, have been resistant to.

Last week, Senator John McCain revived hopes that there could be support for the Simpson-Bowles plan is the Bowles-Simpson plan and said they are prepared to move forward with this as an outline. It is also rumored that a group of Senators, including Lamar Alexander (R-TN) and Michael Bennet (D-CO), said they plan to offer their own proposal based on the debt commission's recommendations during the lame duck.

Legislative Branch

Senate

Senate Banking Committee Begins Examination of High Frequency Trading

On September 20th, the Senate Banking Securities, Insurance and Investment Subcommittee held a sparsely attended hearing on the issue of high frequency trading (HFT) also known as "algo" or "quant" trading. This was the first formal Congressional hearing on the issue and Chairman Reed (D-RI) was clear that, while this particular hearing was intended to provide a base level of information for lawmakers, it would not be the last effort by Congress on this issue. Adding to the sense that HFT will be an issue in 2013 was Ranking Member Crapo's (R-ID) apparent belief that there are issues within the HFT industry that need to be addressed, either by Congress or by the SEC. Crapo noted that over 50 percent Americans are exposed to the equity markets and that there have been "too many technological failures" as of late.

The hearing also exposed a fissure in the industry between those who take a short-term versus long-term view towards accumulating wealth. Summarizing this best was Andrew Brooks, Vice President at T. Rowe Price Associates, whose testimony described HFT as a "casino-like environment" that long-term retail investors have come to distrust. Witnesses as well as Senators Reed and Crapo agreed that any effort to regulate the industry must be done after significant consideration because of the potential complexity such regulation of the industry would take. Still, numerous suggestions of how to bring more stability to the market were offered, including "kill switches," that would shut off access to the market for a trader that exceeded a preset trading limit, placing limits on how long quotes had to be held open and putting bounties out for third parties to create systems to audit trades. Interestingly, at a conference also being held on September 20th, the chief regulator of FINRA, Richard Ketchum, voiced support for the use of "kill switches."

In addition to laying the ground work for future hearings on HFT, it was clear that Thursday's hearing was intended to put pressure on the SEC in advance of the Commission's October 2nd roundtable on Knight Capital and the impact of technology on the stability of markets. A staffer for Senator Reed has been quoted making it clear they hope the SEC revisits a consultation document on market structure issued prior to the Flash Crash, which attempted to find the right balance between competition and risks of increasing complexity amongst high frequency traders.

Congressional Joint Hearing Examines Capital Gains
On September 20th, the Senate Finance Committee and the House Ways and Means Committee met in a joint hearing to examine capital gains in the context of comprehensive tax reform. The hearing comes as, absent Congressional action, on January 1, 2013 the maximum statutory capital gains rate will increase to 20 percent and the maximum individual income tax rate will increase to 39.6 percent. Also beginning in 2013, an additional 3.8 percent tax will be imposed on net investment income earned by certain individuals and the scheduled 2013 restoration of the "Pease limitation" on itemized deductions will impose a roughly 1.2 percent marginal rate on capital gains, bringing the top federal rate on capital gains to 25 percent.

Against this backdrop, witnesses at the hearing stressed that, to be able to accomplish comprehensive tax reform, lawmakers would likely need to close the gap between the tax rate of capital gains and the rate on ordinary income. David Brockway, former Joint Committee on Taxation (JCT) Chief of Staff told Members that 1986 tax reform—which taxed capital gains and regular income at 28 percent and the top bracket at 35 percent—should be a model for overhaul. Similarly, other witnesses asked Congress to focus on fairness and equity issues and recognize the tradeoffs that will have to occur if the capital gains rate is kept low in comprehensive tax reform. However, not all witnesses were in agreement. For example, Dave Verrill, representing the venture capital industry, urged Congress to maintain the 15 percent capital gains rate.

Lawmakers recognized the hurdles ahead of them to reach an agreement on capital gains and there was no clear consensus on how to fold capital gains into larger reforms. Ranking Member of the Ways and Means Committee Sander Levin (D-MI) said most of the benefits of lower capital gains rates will go to those making more than $1 million a year and Chairman of the Finance Committee Max Baucus (D-MT) pushed back on the notion that capital gains are subject to double taxation. Still, Chairman of the Ways and Means Committee Dave Camp (R-MI) said double taxation is a serious problem and Ranking Member Orrin Hatch (R-UT) said the progressive tax code would become even more so by raising capital gains. We expect this issue to continue to draw attention in the lame duck and 2013.

Senate Investigation into JPMorgan Trading Loss Will Stress Need for Strong Volcker Rule
First reported by Bloomberg, the Permanent Subcommittee on Investigations, chaired by Senator Carl Levin (D-MI)—one of the authors of the Volcker Rule, is conducting an investigation of JPMorgan's trading loss from earlier this year. The inquiry seeks to determine if

JPMorgan's trades would have been permitted under the proposed draft of the Volcker Rule. The authors of the proprietary trading ban, Senators Carl Levin (D-MI) and Jeff Merkley (D-OR), have said the JPMorgan loss underscored the need for a strong rule and the importance of its implementation. In addition to the Senate investigation, the SEC and CFTC and a number of other state, federal and international enforcement organizations have been looking into the JPMorgan trading loss. Additionally, an initial internal bank review found that UK traders may have initially sought to hide the size of their losses.

Senate HELP Committee Considers Pension Modernization Options

On September 20th, the Senate Health, Education, Labor and Pensions Committee held a roundtable discussion on ways in which to modernize the pension system for a 21st century workforce. Lawmakers and witnesses recognized that the current pension system is not perfect but largely agreed that the pension system and Social Security need to be strengthened rather than fully reformed and employees need to be educated to understand and appreciated the need for a lifetime benefit. Chairman Tom Harkin (D-IA) said he favors a blend of options including defined benefit plans and 401(k)s—a policy reflected in his July retirement security proposal of Universal, Secure and Adaptable (USA) Retirement Funds. Harkin also noted that work will not begin on overhauling the pension system until 2013 and this hearing was meant to see "where the interconnectors ad outliers are." Harkin asked Witnesses at the hearing included representatives from the Chamber of Commerce, Principal Financial, Retirement USA, SEIU, the American Enterprise Institute and the Center for American Progress.

Corker Asks SEC to Find Common Ground on Money Market Reforms

In a letter sent September 14th, Senator Corker (R-TN) urged the SEC to find a way forward to overhaul the $2.6 trillion money market mutual fund industry. Corker cited concerns that money market funds are "still a real risk" to the financial system and asked SEC commissioners to find "common ground" around rules to "stem a run and the potential need for government intervention." Corker's letter comes after Chairman Mary Schapiro's announcement that she does not have enough votes to advance a proposal that would reform the industry through moving to floating net asset values (NAVs) or maintaining capital buffers.

House of Representatives

Testifying Before House, Cordray Says CFPB Will Reverse Fed Ability to Repay Regulation

On September 20th, in the CFPB's semiannual report before the House Financial Services Committee, Director Richard Cordray said the Bureau is starting a formal rulemaking to reverse a Federal Reserve "ability to repay" provision of the Credit Card Accountability, Responsibility and Disclosure (CARD) Act of 2009. The ability to repay provision is highly unpopular and is said to restrict the ability of stay at home spouses to obtain credit cards. The Fed regulation took effect October 1, 2011 and required credit card companies to consider applicants individual income and assets rather than household—causing many stay at home spouses without an income to be turned away. Cordray told lawmakers that the CFPB will proceed with a rulemaking "in the very near future."

In addition to a discussion of the CARD Act, Chairman Bachus (R-AL) used the opportunity to continue to speak against the CFPB's accountability and transparency. The CFPB's funding and leadership structure has long been a point of contention for Republicans. Bachus reiterated concerns about "lack of accountability" in the agency's leadership, "lack of transparency in the CFPB's funding structure," the absence of checks and balances, and questioned the practice of publishing "raw unverified" consumer complaint data.

Municipal Adviser Bill Passes House
On September 19th, H.R. 2827, which amends the Dodd-Frank Act to limit the application of the term "municipal adviser" to those who are engaged with or compensated by a municipality, passed the House by voice vote. The bill also contains a provision holding advisers to a fiduciary standard. The legislation was prompted by criticism from both the banking industry and municipalities that the SEC rule implementing this provision of the Dodd-Frank Act defined municipal advisers too broadly. However, the proposal could face opposition in the Senate, where Democrats have been resistant to open the Dodd-Frank Act to any changes, fearing to spark repeal efforts.

Fannie and Freddie Bill Pulled from Suspension Calendar
Demonstrating any legislation concerning the federal housing sector will be difficult to accomplish in Congress, the Market Transparency and Taxpayer Protection Act of 2011 (H.R. 2440) was pulled from the suspension calendar (a procedure reserved for non-controversial, bipartisan measures) on September 19th. The bill would require the director of the FHFA to review Fannie and Freddie's portfolios of mortgage patents and determine which ones are "non-mission critical" and could be sold. The version of the bill scheduled to be considered was labeled bipartisan as it included provisions to address Democratic concerns over mortgage data disposal but Representative Barney Frank (D-MA) objected to its consideration as the bill had not been considered since 2011 and had not passed the full Financial Services Committee. Chairman of the Committee Spencer Bachus (R-AL) likewise was unaware the bill was to be considered on the floor and the bill's sponsor, Robert Hurt (R-VA) agreed remove the measure from the agenda.

Waters Cleared by House Ethics Panel
On September 21st, the House Ethics Committee moved towards clearing Congressman Maxine Waters of any clouds caused by allegations that she improperly intervened on behalf of a bank in which her husband had a financial interest. In clearing the Congresswoman, Rep. Robert Goodlatte (R-Va.), who headed the panel investigating Waters, said the case should be closed "because there is not sufficient evidence on the record to prove violations by a clear and convincing standard, which is necessary before sanctions are recommended to the House of Representatives." The move is seen as clearing the path for Congressman Waters to assume the top Democratic position on the House Financial Services Committee in 2013.

Financial Transaction Tax Legislation Introduced
On September 17th, Representative Keith Ellison (D-MN) introduced the Inclusive Prosperity Act (H.R. 6411), a bill to which would tax stocks and other trading transactions to raise new

revenue and discourage high-frequency and speculative trading. The legislation imposes a 0.5 percent on stocks, 0.1 percent on bonds and 0.005 percent on derivatives that are sold by financial institutions. Similar legislation, introduced by Representative Peter DeFazio (D-OR) and Senator Tom Harkin (D-IA), would impose a 0.03 percent tax on the sale of these financial products. The financial transactions tax, referred to as the Robin Hood or Tobin tax has been more popular in Europe but has yet to catch on in the UK and the US. Treasury Secretary Geithner has resisted such as tax, citing fears it could damage the financial sector.

House Financial Services Committee Examines the Fed's Interest Rate Policy
On September 21st, the House Financial Services Domestic Monetary Policy and Technology Subcommittee met to examine the Fed's zero interest rate policy and the price of money. Representative Ron Paul (R-TX) chaired the hearing, saying "manipulation of interest rates – essentially price setting – can only ever have destructive effects on the American economy." Witnesses included James Grant of Grant's Interest Rate Observer and Lewis E. Lehrman, of L.E. Lehrman & Co.

<u>Executive Branch</u>
CFPB
Industry to CFPB: QM Rule Must Be Broadly Defined
On September 14th, ten financial trade organizations wrote to the CFPB to stress their support for a broadly-defined qualified-mortgage (QM) rule, including safe harbors for lenders meeting the rule's definition. The letter called for QM requirements to be "based on objective bright line standards" and reminded regulators that "all segments of the mortgage industry" support a broad QM definition. Before the Senate Banking Committee two weeks ago, CFPB Director Cordray told lawmakers that the Bureau is taking a cautious approach to crafting QM due to its potential to have a large impact in reshaping how home loans are underwritten. Still, the Bureau expects to meet the January 21, 2013 statutory deadline for the rule. The letter was signed by American Bankers Association, American Financial Services Association, Community Mortgage Banking Project, Consumer Bankers Association, Consumer Mortgage Coalition, Credit Union National Association, Housing Policy Council of the Financial Services Roundtable, Independent Community Bankers of America, Mortgage Bankers Association, and the National Association of Federal Credit Unions.

CFPB Announces First Meeting of Consumer Advisory Board Next Week
On September 27th, the CFPB will hold the inaugural meeting of the Consumer Advisory Board in St. Louis, Missouri. The Consumer Advisory Board is a group of experts charged with identifying and assessing the impact of emerging products, practices, or services on consumers and other market participants. Director Richard Cordray, the Chair and Vice Chair of the Consumer Advisory Board, board members, and members of the public will deliver remarks. More information and RSVP details can be found here.

SEC
Majority of Commissioners Call for Study of Money Market Reforms

On September 17th, SEC Republican Commissioners Daniel Gallagher and Try Paredes and Democratic Commission Luis Aguilar wrote to Chairman Schapiro and Chief Economist Craig Lewis asking for an analysis of the effect certain rules could have on money-market funds and short-term credit markets. The request for the study follows Schapiro's cancelled vote on new money-market proposals and a letter from Senator Corker requesting Commissioners find common ground to reform the industry. Gallagher and Paredes have said they support alternative reforms that would allow money funds to prohibit withdrawals to stop investor flight should a run occur.

SEC Investigating Payments of Private-Equity Firm Investments
The SEC is attempting to determine if some private-equity firms are taking more profits from investments than they should under agreements with clients. In a review of the private-equity industry which began after the passage of Dodd-Frank, the SEC is investigating how buyout funds ensure payouts follow the sequence set in partnership documents. Specifically, regulators are examining the distribution process, or the waterfall, that requires clients to receive gains from investment before the firm. The investigation is prompted by fears that firms lack the internal controls to track payments and ensure the waterfall plan is followed. As part of the examination, the SEC has asked firms for information on how broken-deal expenses are allocated.

SEC Announces Record Breaking Amount of Stock Trading Suspensions
On September 17th, the SEC announced that so far in 2012 it has suspended the stock of 609 companies from trading—the highest number of trading suspensions ever issued in a single year. The SEC has the authority to suspend trading in a company's securities for up to ten days should the agency see the action in the public interest. This year also set a record for the most suspensions in a single day; on May 14th the SEC announced 379 dormant shell companies were barred from trading.

CFTC

Gensler to Co-Chair International Organization of Securities Commissions Task Force
On September 14th, CFTC Chairman Gary Gensler was named co-chairman of the International Organization of Securities Commissions (IOSCO) task force—a body created to define benchmarks relevant to financial markets and develop global guidance for benchmark and self-regulation. The task force will be responsible for coordinated enforcement action against Barclays Bank PLC, which will pay over $450 million to the CFTC, the U.S. Justice Department, and the UK's Financial Services Authority to resolve allegations that it manipulated submissions to LIBOR and EURIBOR. In addition to this enforcement, IOSCO will be responsible for surveying current global initiatives "with a view to avoiding overlap of inconsistencies" in policy.

FDIC

Gruenberg Address Volcker, TAG in Remarks
In remarks before the American Banker Regulatory Symposium, Acting Chairman Martin Greunberg said regulators are continuing work to finish the Volcker Rule and the goal is to finalize it by the end of the year. In other remarks, Gruenberg said the fate of the Transaction

Account Guarantee (TAG) program is in the hands of Congress. TAG provides full depository insurance above the FDIC's $250,000 threshold and currently covers about $1.3 trillion in deposits. Meant as a backstop against runs during the financial crisis and recovery, the program is set to sunset at the end of 2012. "We're at the point where Congress is going to have to make the judgment whether to extend the program," said Gruenberg, adding that Congress should consider financial stability when making the decision.

Hoening Continues Calls for Reinstatement of Glass-Steagell Separations
On September 19th, FDIC board member Thomas Hoenig spoke before the Exchequer Club calling for the separation of commercial banking from investment banking. Hoenig told audience members that despite the added regulations the government safety net has grown since the financial crisis and reverse incentives leading to the crisis remain, allowing banks to return to risky behavior due perceived safety. The Volcker Rule, argued Hoenig, will not stop the safety net from covering important elements of the derivatives trading and market-making activities—which have the potential to become 'veiled' proprietary trading. "The behavior and practices leading to this crisis," said Hoenig, "will soon reemerge and these highly complex, more vulnerable firms will have an even more devastating effect on the economy."

<u>International</u>
Brazil Criticizes Additional US Quantitative Easing
Last week, Brazil's finance minister, Guido Mantega, attacked the US for a "protectionist" move to pursue additional quantitative easing, saying the accommodative monetary policy will rekindle currency wars by depressing the dollar. Mantega pointed to Japan's decision to also expand its QE program as evidence that the "currency war" has begun.

UPCOMING HEARINGS

The Senate and House Are in Recess