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FINANCIAL SERVICES REGULATORY REFORM UPDATE

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Despite efforts by some on the far right to convince otherwise, it is becoming even clearer that the market is reacting to the possibility that politics will prevent Congress from rising the debt ceiling and avoiding a US default. As it was widely reported this week, the cost of insurance against a US sovereign debt default is on the rise, with the gross value of derivatives contracts that pay out in the event of a having doubled from where it was one year ago. With the House set to engage in the epitome of political theater next week when it votes on Ways and Means Chairman Dave Camp's bill to provide a "clean extension" (i.e., increasing the debt limit by $2.4 trillion, without any accompanying spending cuts) it will be interesting to see how Wall Street reacts. Apparently, Camp and others in the Republican leadership have been calling key folks on Wall Street to explain the politics behind this maneuver. While that is all well and good, it is unclear if they have reached out globally to other key financial sectors (London, Tokyo, etc) to explain why the defeat of this bill will be necessary as a symbolic victory for conservatives, who are eager to have a vote against a debt limit increase on the books for their constituents, who may not be cognizant of the subtle domestic politics at play and may react more cautiously about their debt holdings.

Meanwhile discussions continue on parallel tracks between the two groups attempting to reach a solution for implementing long term deficit reduction. While one, the Gang of Six, seems to be descending in importance and likelihood of result, and the other, the group lead by the Vice President is ascending in terms of prestige, it is clear that the results of the special election in New York have impacted the debate.

DEBT CEILING AND BUDGET NEGOTIATIONS CONTINUE

After Sen. Tom Coburn (R-OK) departed the Gang of Six last week, the remaining five Senators (Dick Durbin (D-IL), Kent Conrad (D-ND), Mark Warner (D-VA), Mike Crapo (R-ID) and Saxby Chambliss (R-GA)) met this past Tuesday to discuss the potential release of a deficit-reduction proposal to which the group almost agreed prior to Coburn's exit. Durbin urged the two GOP members to issue the proposal, which, if adopted, would cut the deficit by $4 trillion over the next decade. The proposal is based roughly on the Simpson-Bowles plan that was issued by the President's bipartisan deficit commission in 2010. Durbin argued that more people should see the plan, which would serve as a starting point for debate and remain open to amendment.

The release remains uncertain, with Crapo and Chambliss unwilling to stick out their necks (politically) to support a plan without the backing of their colleague Coburn. Many GOP members similarly feel that a deficit reduction plan not endorsed by Coburn stands little chance of moving forward. Durbin has stated that Coburn will not be replaced in the Gang of Six, and is shifting his efforts to encourage Senators from both parties to push the current Gang to release the proposal. Previously, 64 Senators, led by Michael Bennet (D-CO) and Mike Johanns (R-NE), sent a letter to President Obama in March, urging him to support the efforts of the Gang. Durbin appears to be seeking more examples of this kind of support, but in all likelihood, Republicans are not likely to be supportive of the Gang of Six as they have in the past, because unlike Biden's group, there is a growing concern that the lack of an official White House nexus to the group would allow Obama to ultimately distance himself from the more controversial recommendations in the 2012 election.

That, among other reasons is why the group lead by Vice President Joe Biden and key members of Congress from both parties has taken center stage. His group met twice last week, and Biden reported progress on Tuesday with a "down payment" plan that would start off with over $1 trillion in deficit reduction right off the bat. The hope is that this preliminary plan could calm markets and set the stage for a larger compromise plan later on. The group has also agreed on $200 billion in spending cuts, including agriculture subsidies.

The group is taking its confidentiality quite seriously, but reportedly spoke about mechanisms that would make automatic cuts unless certain goals are met. Biden's goal is to formulate a plan that would reduce U.S. debt by $4 trillion. Biden has emphasized that tax revenues have to be a part of any deal, and Democrats in the meeting refused to make any compromises on Medicare until Republicans agreed to put raising tax revenue on the table. However, House Majority Leader Eric Cantor (R-VA) has already stated that "tax increases cannot pass the House."

We continue to expect a deal on the debt ceiling this summer, and that any deal will include some spending cuts. It is worth noting that experts estimate that raising the debt ceiling by $2.4 trillion is the amount of debt from President Obama's budget through 2012, so that may become the *de facto* target number for a deal. As indicated above, despite the assertion of Senator McConnell and others, the markets are beginning to get skittish about the possibility of real default, and it will be very interested to see how the markets react to the vote in the House next week. Our sense is that it will take a real event to knock McConnell and others off their talking points.

WARREN FENDS OFF CFPB NOMINATION QUESTIONS AT CONTENTIOUS HOUSE OVERSIGHT AND GOVERNMENT REFORM SUBCOMMITTEE HEARING

On May 24^{th}, at a House Oversight and Government Reform Subcommittee hearing, CFPB advisor Elizabeth Warren faced aggressive questioning on the agency's regulatory initiatives and her personal plans for the future. While Warren was largely able to dodge questions concerning a possible recess appoint to head the agency, she faced heated questioning from Subcommittee Chairman McHenry and other Republican members on mortgage services reform, the power of the CFPB, the agency's funding structure and the Bureau's system for handling consumer complaints.

Although the White House stressed that it was not planning on putting Warren in through a recess appoint at this time, House Speaker Boehner exercised his option to require the Senate to go into *pro forma* sessions this week to prevent an actual recess from occurring. The Bureau is going "live" on July 21st and as of today it is unclear who, if anyone will be the director on that day.

HOUSE COMMITTEE APPROVES DELAYED DERIVATIVES RULEMAKING

On May 24th, the House Financial Services Committee agreed to legislation that would delay the implementation of the derivatives and swaps market reform portions of the Dodd-Frank Act for two years. Rulemakings that would be affected by this legislation would likely include rules on capital requirements and governance standards for swaps dealers, and regulations that would create swap execution facilities or exchanges. H.R. 1573 was referred to as a "common-sense bill that gives regulators additional time and information to engage in the proper due diligence…" by Committee Chairman Spencer Bachus (R-AL), and was approved by a party-line vote of 30-24, with some members of the New York delegation who had sent the letter to Gensler urging for delays in his rulemaking, missing the final vote (though two members who signed the letter, Carolyn Maloney and Greg Meeks voted against the proposal). It is worth noting that this legislation does not make any modifications to the actual substance of the Dodd-Frank reforms, and instead only changing the deadlines for certain provisions would be extended, including changing the effective date of the entire derivatives title to September 30, 2012.

As expected, Representative Barney Frank spoke out against the bill, charging that "it's not a bill to give the regulators more time—it is a bill to prevent the regulators from acting." The Agriculture Committee, which shares jurisdiction over the CFTC with House Financial Services, has already approved the bill to proceed to the House floor. Despite support in the House, if passed, it is unlikely to succeed in the Senate.

SENATE BANKING SUBCOMMITTEE EXAMINES DERIVATIVES CLEARINGHOUSES

While the House Committee approved legislation to delay implementation of derivatives regulation, a Senate Banking Subcommittee hearing discussed the merits and challenges of establishing derivatives clearinghouses. While there was no significant opposition to the implementation of derivatives rules in the hearing, several witnesses expressed concerns about concentration of risk and the process for implementing the rules.

CME Group Chairman Terry Duffy said that the creation of an OTC swaps clearing market should be staged in major steps and provide for adequate resources to mitigate risk. Another witness echoed that sentiment, saying the biggest challenge to derivatives clearing will be mitigating systemic risk within clearinghouses. Subcommittee Chairman Jack Reed said that his sense is that the "SEC and CFTC are moving, deliberately and responding to the industry" to implement derivatives rules and that "there was no outcry to stop it or postpone" implementation. Republican Senator Toomey said he did not oppose the creation of clearinghouses so long as implementation is sequential and there is enough time allowed for industry to adjust.

Meanwhile, despite statements at the hearing expressing concerns about a lack of progress in Europe on this issue, on May 24th, the European Parliament Committee for Economic and Monetary Affairs agreed to legislation that would require OTC derivatives to be centrally cleared. The rules, if agreed to by the full Parliament and EU member states, exempt entities which use derivatives contracts to hedge against currency and interest rate fluctuations.

POTENTIAL EXTENSION OF SWAPS RULES CAUSES INTERNATIONAL BACKLASH

According to a Wall Street Journal article published this week, foreign banks and funds are becoming increasingly concerned that U.S. regulators will extend their activities overseas and enforce risk mitigation portions of the Dodd-Frank Act abroad. Current proposed rules allow regulators to regulate the swaps market and require that all foreign entities to conduct swaps in an exchange, post margin and hold sufficient capital.

Foreign central banks have already been outspoken on the potential for international actions by U.S. regulators. The European Central Bank (ECB), the Bank of France, China's sovereign wealth fund and the China Investment Corporation have all signaled their displeasure and said the regulations would be an overstep of U.S. authority. A May 6th letter from the ECB to U.S. regulators said "it would be inappropriate to be subject to supervisory requirements by a non-EU authority."

The CFTC and SEC are currently reaching out to the Fed for guidance on international swaps rules. According to U.S. officials, one option regulators could pursue to exempt foreign banks would be to exclude entities that are well-regulated or that are well-capitalized from regulation; however, no decisions have been made.

U.S. regulators have expressed that there are good reasons to include some foreign institutions in their rulemaking, including sovereign wealth funds. Michael Barr, a former Assistant Secretary at the Treasury Department said "it makes sense to treat sovereign-wealth funds the way you would any other financial player in the marketplace" and that they "ought to be bound by the same rules because derivative transactions with them pose the same risks to the financial system as transactions with hedge funds and other investment vehicles."

CFTC Commissioner Jill Sommers, who has been outspoken in her dissent to several aspects of regulatory reform, said that foreign entities have legitimate concerns and their views should be factored into final rules. Additionally, when she testified before the House Agriculture Subcommittee on General Farm Commodities and Risk Management, Sommers warned that there are substantial differences between U.S. derivatives reform and international efforts.

BRITISH COMMISSION REPORT SIGNALS HIGH CAPITAL REQUIREMENTS

Under current plans being considered by the British Independent Commission on Banking, British banks could be subject to capital requirements up to half as much as their minimum equity. An interim report by the Commission, released in April, called for banks to hold equity capital equal to at least 10 percent of their risk-weighted assets. The final report is due to be presented in September and will define how large the debt buffer for British banks must be.

The report is being said to follow the standards set by Switzerland which go beyond the requirements set by international regulators at the Basel Committee. Currently, regulators are working on drafting Basel III which—according to a Financial Times report—could ease some of the tight capital requirements. A draft report of the Basel III document is said to allow banks to apply capital in their insurance subsidiaries to meet the requirements. Banks would also be allowed to continue using hybrid capital.

SEC ADOPTS FINAL WHISTEBLOWER RULES

As required by Dodd-Frank Section 922, the SEC adopted final rules for a whistleblower program on Wednesday, by a vote of 3-2 that would impact any publicly traded company in this country. The rules explain the procedure by which individuals can become eligible and file a claim for an award, including the completion of a newly-approved Form-TCR, which will be available on the SEC's website. Dodd-Frank explicitly prohibits retaliation by employers against whistleblowers, as defined under SEC rules (even if they are not eligible for a reward), and creates a private right of action for whistleblowers who are discharged or discriminated against by employers in violation of Dodd-Frank. The rules will become effective on the later of the date they are published in the Federal Register, or are provided to Congress. More details on the rule are available here.

GRASSLEY ASKS SEC FOR CLARIFICATION ON INSIDER TRADING REFERRALS

On May 24th, in a letter to the SEC, Senator Grassley asked for the agency to provide clarity on the actions it took regarding the hedge fund SAC Capital Advisors LP, where two of its former portfolio managers face insider trading charges. Grassley expressed that his aim is to ensure that the SEC properly policies financial markets and that "Looking into specific examples is essential for Congress to understand how effectively the SEC pursues referrals." The SEC has yet to comment on the letter.

UPCOMING HEARINGS

The Senate is in pro forma session and no major hearings are planned in the coming week.

On Wednesday, June 1st at 10am, in 2128 Rayburn, the House Financial Services Committee will hold a hearing to receive the Treasury Department's annual report on the state of the international financial system. Treasury Secretary Timothy Geithner is scheduled to testify.

On Wednesday, June 1st at 1pm, in 2360 Rayburn, the House Small Business Committee will hold a hearing titled "Access to Capital: Can Small Business Access the Credit Necessary to Grow and Create Jobs?"

On Wednesday, June 1st at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on Domestic Monetary Policy and Technology will hold a hearing titled "Federal Reserve Lending Disclosure: FOIA, Dodd-Frank, and the Data Dump."

On Thursday, June 2nd at 10am, in 1100 Longworth, the House Ways and Means Committee will hold a hearing on major business and corporate tax issues, focusing on the taxation of domestic business operations.

On Thursday, June 2nd at 10am, in 2128 Rayburn, the House Financial Services International Monetary Policy and Trade Panel will mark up draft legislation that would reauthorize the Export-Import Bank of the United States.

On Thursday, June 2nd at 10:30am, in 210 Cannon, the House Budget Committee will hold a hearing titled "Fannie Mae, Freddie Mac and FHA: Taxpayer Exposure in the Housing Markets."

On Friday, June 3rd at 10am, in 2128 Rayburn, the House Financial Services Committee will hold a hearing titled "Oversight of HUD's HOME Program."

On a date TBD, in 2128 Rayburn, the House Financial Services Committee will hold a hearing on an independent study conducted by the Boston Consulting Group on a proposal to overhaul the Securities and Exchange Commission. (originally scheduled for June 3rd).