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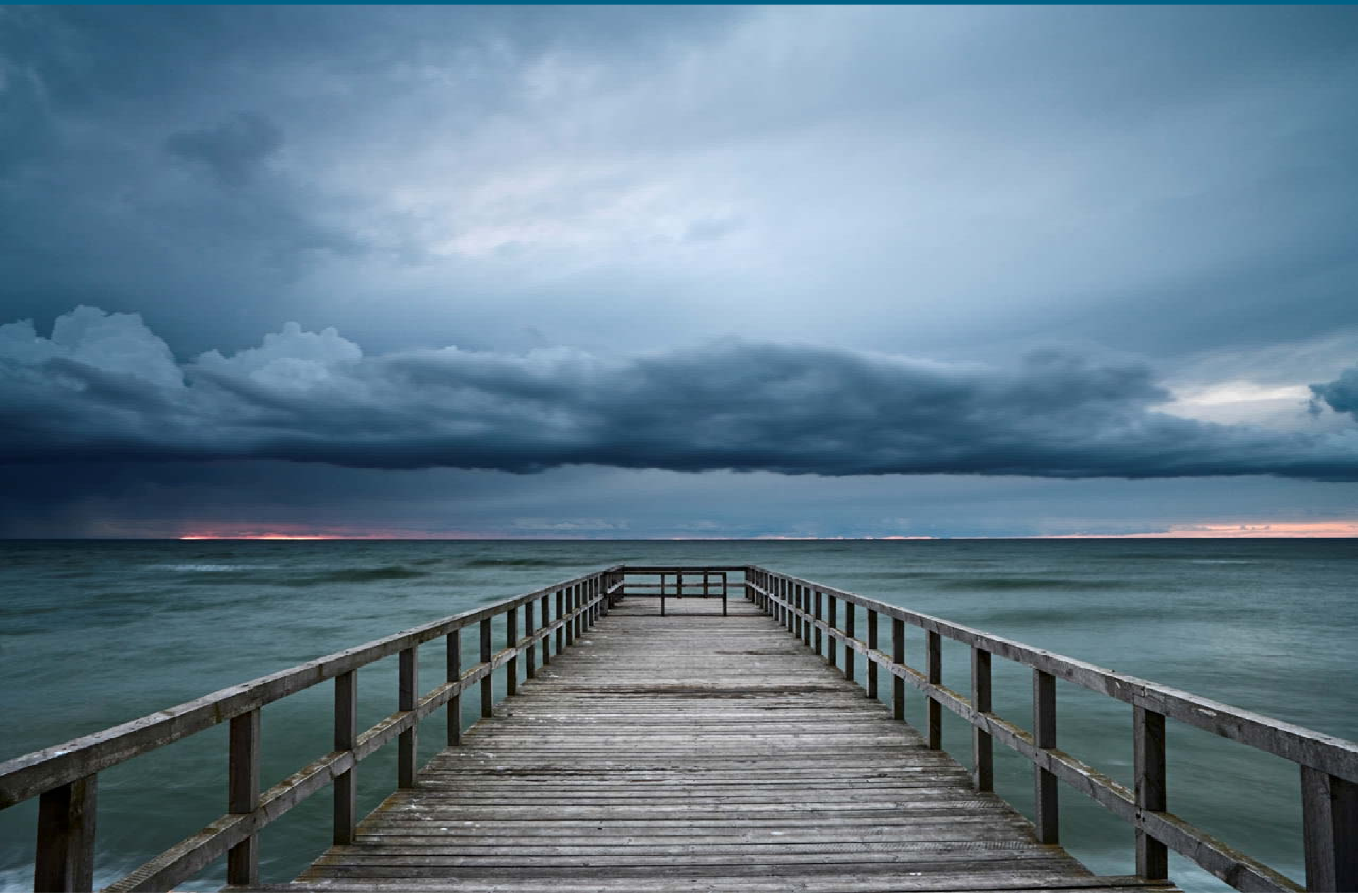
Evolving Regulatory Reform

U.S. Financial Regulatory Reform:

Derivatives Regulation and the Blanche Lincoln Derivatives Spin-Off Amendment

(Update May 13, 2010)



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U.S. FINANCIAL REGULATORY REFORM:

DERIVATIVES REGULATION AND THE BLANCHE LINCOLN DERIVATIVES SPIN-OFF AMENDMENT

(Update as of May 13, 2010)

This paper provides an update on the current debate in the United States Senate on Financial Industry regulatory reform. It focuses, in particular, on the Blanche Lincoln amendment to the proposed Senate bill that would require banks to split off their derivatives activities into a separate subsidiary.

Executive Summary

- **A Financial Industry reform bill has already passed the House and is waiting for a Senate bill. These two bills will then be reconciled in a House-Senate Conference and the resulting compromise bill will be passed by both houses into law.**
- **The bill drafted by the Senate Banking Committee under Senator Chris Dodd is currently under active consideration in the full Senate.**
- **Given the anti-Wall Street sentiment in the country combined with the recent civil suit filed by the Government against Goldman and its associated Senate hearings, it is clear that the Senate bill *will* be passed.**
- **As part of the current consideration of the Senate bill, there are over 175 amendments under active consideration. To date, as these amendments have been considered, the bill has become increasingly more radical as both Republicans and Democrats position themselves for the coming fall election. No Senator on either side of the aisle wants to be seen as being pro-Wall Street.**
- **Blanche Lincoln, Chair of the Senate Agriculture Committee, has proposed requiring banks to split off their derivatives activities into a separate subsidiary.**
- **While all of the major regulators have advised against the adoption of the Lincoln amendment, in the current political environment, and with the Administration tilting aggressively towards the more progressive / radical, it is increasingly possible that the Lincoln Amendment will be adopted by the Senate.**
- **If the Dodd bill with the Lincoln amendment is passed, the Lincoln amendment might still be dropped or "watered down" in the House – Senate Conference to reconcile the two bills. This, however, would require the active leadership of Representative Barney Frank.**
- **The actual impact of the amendment, if it is adopted, may not be great since Morgan Stanley has its swaps operations today in a non-bank subsidiary and seems not to be overly hampered in their activities. The greatest impact seems to be on capital and profitability of the business.**
- **Other, less visible amendments will have a greater impact than the Lincoln amendment.**
- **The debate over the next few weeks will prove critical to formulation of a bill that will fundamentally reshape the financial system.**

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Introduction

As the Senate continues to debate the massive 1,500 page financial industry regulatory reform bill ("The Dodd bill"), Wall Street is on the defensive, facing the likely prospects of a massive series of significant legislative proposals being adopted which would have a far-reaching impact on the industry.

The Senate bill and its proposed amendments come at a time when the power and influence that the financial industry once had in Washington has waned and its ability to fend off ill-conceived / damaging proposals has diminished as a wave of anti-bank fervor has washed over the country and Washington, D.C.

Stoked by White House rhetoric about "fat-cat bankers," the anti-Wall Street mood in Washington has many Senators on both sides of the aisle fearful of voting for any measure deemed to weaken Wall Street reform and protect big banks. This fear of being perceived as pro-Wall Street was amplified by the recent Government civil suit against Goldman Sachs and the associated public hearings, so elegantly timed (it seems) to support the passage of the Dodd bill. As a result of this anti-Wall Street mood, proposals which never had a chance of being approved in previous years are now being given serious consideration, and many of them might even be enacted into law.

As the *New York Times* noted last week (May 6, 2010), "the confluence of a high-stakes election year and a pervasive anti-Wall Street sentiment after the recession has given liberals unusual muscle in the debate." Republican Senator Judd Gregg said recently that "rampant pandering populism has taken over Washington." Another Senator said that the bill is now "all about politics" and that the Senate floor debate "has turned into a circus" and a "free-for-all."

Consequently, efforts to weaken the bill's provisions on the Senate floor will be difficult and amendments to impose even tougher rules and restrictions on Wall Street could very well be adopted by the Senate.

Major Provisions of the Dodd Senate Bill

The Senate financial regulatory reform bill would establish broad and substantive new authority for regulators to limit the scope and activities of financial companies, address systemic risks posed by firms, and prevent future taxpayer bailouts. The bill would also impose widereaching new regulations on derivatives, new oversight of hedge funds, create a new Consumer Financial Protection agency, and give shareholders a say on executive compensation and corporate governance.

Excluding derivatives which are covered later, some of the specific initiatives currently in the bill include:

Consumer Financial Protection

- The bill establishes a Consumer Financial Protection Bureau within the Federal Reserve (like the Consumer Products Safety Commission)
- The Bureau will have the authority to write consumer protection rules for all entities, banks and non-banks, that offers consumer financial services or products
- The bill gives authority to the group to examine and enforce regulations for large banks and credit unions, all mortgage-related businesses, and large non-bank financial companies

Initiatives Designed to Address Systemic Risk and Prevent Bailouts

- The bill calls for the establishment of a Financial Stability Oversight Council to monitor and address systemic risks
- Authorizes the Federal Reserve to impose stricter capital, leverage, liquidity, risk management processes, and other requirements
- Authorizes the Federal Reserve to regulate, and if necessary, break up any large non-bank financial institution whose failure could pose a risk to the financial stability of the U.S. Large financial firms will be required to submit contingency plans to regulators for their rapid and orderly shutdown should events warrant.
- Requires regulators study whether to ban proprietary trading and investments in hedge funds and private equity funds by banks
- Gives the FDIC the authority to liquidate failing systemically important financial companies outside of the normal bankruptcy process
- Restricts the Federal Reserve's emergency lending authority

Corporate Governance Rules

- The bill mandates that shareholders must have a significant voice in the compensation of executives at companies
- The bill also gives the SEC the authority to grant shareholders proxy access in order for them to nominate directors
- These are significant initiatives which have been rejected in the past and which will have a profound impact on the way companies are governed

Registration and Regulation of Hedge Funds

- Requires hedge funds ($100 million plus) to register with the SEC as investment advisors. As such, they will be required to provide information about their trades and portfolios necessary to assess systemic risk
- Requires the SEC to share this information with the Financial Stability Council as part of that group's mandate to monitor systemic risk.

Proposed Amendments to the Senate Bill Under Consideration

In addition to these parts of the current bill, over 175 amendments have been proposed by Senators and are under active consideration. While one amendment would ease the bill's restriction on bank derivative trading, most of the amendments propose tougher limits, restrictions, and taxes on the industry. The following are a list of some of the more significant amendments to the bill currently under consideration:

- Caps on credit card interest rates
- Requires audits of Federal Reserve operations (This amendment has already been adopted)
- Limits the size and leverage of big banks (The initial amendment was defeated, but is in the process of being re-worked and will be re-considered. It is likely to pass in some form.)
- Re-impose Glass-Steagall restrictions
- Place new restrictions on bank trading activities, including limits on hedging
- Mandate SEC study of limiting short-selling and high frequency trading

- Restrict Asset Backed Securities activity with “no material economic purpose”
- Ban “naked credit default swaps”
- Require registration and reporting of private equity and venture capital funds
- Impose new taxes on the industry (For example, proposed changes in carried interest tax laws will appear shortly in a separate bill.This will have a major impact on the hedge fund industry.)

The Blanche Lincoln Amendment: The New Regulation of Derivatives

Recently, the Administration unexpectedly threw its support toward more radical reform measures, and, the Senate bill has become increasingly more and more progressive / radical. The Blanche Lincoln amendment requiring banks to segregate their derivatives activities into wholly-owned subsidiaries is but one example of increasingly radical amendments being added to the bill.

As noted above, the Senate bill includes the derivatives legislation drafted by Senator Blanche Lincoln and approved by the Senate Agriculture Committee she chairs. (The Agriculture Committee has had historical jurisdiction because of farm commodities.) The provisions of her bill have been melded into the Dodd bill approved by the Senate Banking Committee. The entire package will be offered on the Senate floor as a substitute amendment to the original Dodd bill at some point during the debate.

According to Senator Lincoln, her “Wall Street Transparency and Accountability Act of 2010” is “landmark reform legislation that will bring 100 percent transparency to an unregulated $600 billion market, close all loopholes, and keep jobs on Main Street.” If adopted, the Senate bill would include the following derivatives changes:

- The bill would provide the SEC and CFTC with authority to regulate over-the-counter derivatives
- Require central clearing and exchange trading for derivatives that can be cleared
- Provide Treasury with the authority to regulate foreign exchange transactions
- Impose a fiduciary duty for swap dealers in deals with municipalities and pension plans
- Force banks to spin-off their derivatives business, or to set up separately-capitalized affiliates (“Lincoln Amendment”)

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The Blanche Lincoln Proposed Bank Derivatives Spin-Off Amendment

The proposed Lincoln bank derivatives spin-off amendment has become one the most controversial provisions of the regulatory reform legislation in the Senate. The provision, which was Section 106 of the original Agriculture Committee bill and is now Section 716 of the Banking Committee bill, would require most derivatives activities to be conducted outside of banks.

The provision has encountered growing opposition from multiple sources, and many observers believe it ultimately will be modified or dropped from the bill. Bank regulators have warned that the provision would result in less regulatory oversight, the Administration has failed to endorse the Amendment publicly, and industry groups have warned it would have a destabilizing impact on banks, costing them billions of dollars in revenue.

However, Senators face a tricky political dilemma in winning approval of any compromise provision which could be viewed as weakening Wall Street reform in the midst of the current anti-big bank fervor.

Background to the Lincoln Amendment

The tough derivatives language adopted by Lincoln's Senate Agriculture Committee surprised most observers, who had expected the committee to approve a moderate bipartisan reform package. However, the White House decided it wanted to be tough on derivatives and pushed Lincoln to write a stronger, more progressive / radical derivatives bill.

Out of the blue, the President announced he would veto any bill that did not strongly regulate derivatives. Lincoln is running for re-election in the fall as one of the most endangered of the Democratic Senators, facing a challenger from the left in a Democratic primary. Recently, to bolster her chances in the primary, she decided that she was not going to be seen as weak on derivatives and Wall Street reform.

When the Banking and Agriculture Committees met to combine their respective bills, the more moderate Dodd language on derivatives was expected to prevail. However, one of Lincoln's female colleagues, Senator Maria Cantwell from Washington, an anti-derivatives Senator, berated Dodd at a Democratic luncheon for "ganging up on the girls (in the Senate)" and jeopardizing

Lincoln's re-election campaign. Cantwell praised the Lincoln bill as a tough "stare down of Wall Street" and urged fellow Democrats to "hang tough" on derivatives. Another colleague, Republican Senator Olympia Snowe, also urged Dodd to adopt the Lincoln bill. Dodd quickly relented and agreed to include the stronger Lincoln provisions in the Senate bill.

Growing Opposition to the Lincoln Amendment

In a recent letter to Senators Dodd and Lincoln, FDIC Chairman Sheila C. Bair expressed her strong concern with the Lincoln derivatives spin-off provision. Bair wrote that "if all derivatives market-making activities were moved outside of bank holding companies, most of the activity would no doubt continue, but in less regulated and more highly leveraged venues." Bair said that most of the activity would move to "nonbank financial firms such as hedge funds…or to foreign banking organizations beyond the reach of federal regulation."

Bair also noted her concerns about pushing the activity into a separate affiliate, which would have less capital and liquidity and "would be beyond the scrutiny of the FDIC." The result "would be weakened, not strengthened protection of the insured bank," she wrote.

The Federal Reserve has also expressed its strong opposition to the proposal and urged that "it be deleted" in a memo to the Senate. In its memo, the Federal Reserve said the provision would "impair financial stability and prudential regulation of derivatives," "be highly disruptive and costly for banks and their customers," and "have consequences for the competitiveness of the U.S. financial institutions."

Finally, Paul Volcker, an adviser to the President and former Federal Reserve Chairman, has registered his opposition to the proposal. In a letter to Senator Dodd late last week, Volcker said that "the provision of derivatives by commercial banks to their customers in the usual course of a banking relationship should not be prohibited."

The Debate Going Forward

Lincoln is holding her ground and not backing away from her proposal. She said it is "absolutely false" that her provision would push derivative trading beyond the reach of regulators, saying every swaps dealer will be subject to strong regulation by the SEC and CFTC. In a response to the Volcker letter, Lincoln resorted to a populist argument against big banks. The Senator, who faces the voters in a Democratic primary May 18, said that there was nothing in the financial reform legislation "to address the massive size" of banks and that her provision was needed to "cut down the size" of the big banks.

Incredibly, Treasury Secretary Geithner has said that the Administration is not prepared to take a formal public position on the provision. He did, however, suggest that he did not support it, stating that it "creates a less stable system."

Potential Compromises

Several Republican Senators have introduced amendments to the bill which would delete the derivatives spin-off provision, but these are not likely to pass the Senate. (A Republican derivatives alternative was voted down on Wednesday, May 12th.)

The more likely outcome is a move either by Dodd or some other Democratic Senator to modify the Lincoln language. One potential compromise might be to allow banks to continue trading most derivatives and require only "the riskiest" derivatives, such as credit derivatives, to be moved into an affiliate.

Modifying the Lincoln language, however, will not be easy in the current political environment. Consumer and labor groups are pushing for the provision, and the White House continues its heated rhetoric on tough derivatives regulation. Even though there is a consensus among bank regulators, administration officials, and moderate Democrats and Republicans to drop the provision, one observer has noted, "Given the public mood, no Senator wants to be linked to its death."

One final possible resolution would be to allow the bill to pass the Senate as is and then drop or "water down" the Lincoln provision in conference. Under this scenario, the banks would have to rely on the House Chairman of the conference, Barney Frank, to resolve the problem.

Lincoln, Volker, and Levin

We believe that in the end there is a chance that some accommodations will be made with respect to the Lincoln language, allowing banks to continue to engage in derivatives activity either in the bank or in a separately-capitalized subsidiary.

If the Lincoln amendment remains in the final law, its actual impact may be less than the amount of impassioned discussion that has occurred to date over the amendment. Morgan Stanley already houses its swaps business in a non-bank subsidiary and that does not seem to impede their activities. The real result of the spinning off of the derivatives businesses into separate subsidiaries would be in cost and profitability, since bank-holding companies generally have higher cost of funds than bank subsidiaries. Estimates of the extra bank capital that would be required range from $20 billion to several times that amount.

The Lincoln amendment aside, we are more concerned that a number of other significant amendments have not been getting the same public notice as the Lincoln amendment. Many of these have been gaining support in the Senate while the industry has spent so much time and energy fighting the Lincoln proposal.

For example, as noted earlier, one amendment being offered by Senators Levin and Merkley would ban all proprietary trading by banks, writing into law the Volcker rule proposed by the White House. The amendment would replace the Dodd bill's language, which provides bank regulators with flexibility to define and regulate proprietary trading.

The Senate will also consider a measure to reduce conflicts of interest by preventing a firm from hedging securities underwritten by the firm and sold to clients. These and other possible measures could result in substantial changes in the way firms interact with clients and trade for their own accounts.

It is a sign of our political times that the Senate bill, which is generally viewed in Washington, D.C., to be deeply flawed, continues to move forward, is becoming increasingly radical, and is expected to pass the Senate by a large margin of votes.

The **Global Sage** Public Policy Advisory Group is headed by Bruce Thompson, a Washington veteran with more than three decades of experience working on public policy issues in both the public and private sectors. Bruce has been deeply involved in every significant public policy debate involving the financial services industry. He was Head of the Merrill Lynch Global Government Relations Office for 22 years. Before that, he served at the Treasury Department as Assistant Secretary for Legislative Affairs under Don Regan and Jim Baker. Prior to Treasury, he worked in the U.S. Senate for seven years.

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