ViewPoint: Financial Services Regulatory Reform

A Discussion of Proposed New Rules and Legislation

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Congress and regulatory agencies have been considering various measures to strengthen the regulatory framework governing the financial services industry for over a year. The past month has seen a flurry of activity, and clarity is beginning to emerge on a number of fronts. Although firm decisions have yet to be taken, and current proposals may change considerably before they are finalized, we would like to share our thoughts with you on a number of issues that could have a broad impact across companies, products and markets.

Several provisions are under consideration that, in our view, could have negative or unintended consequences for investors, and we are working diligently to analyze their potential effects so that our clients are prepared. We will continue to actively engage members of Congress and others in Washington on proposals in the reform package that we believe could be improved. We would also encourage you to reach out to decision makers to raise any concerns you may have with any elements of the regulatory overhaul.

Status of Current Legislation—A Lot on the Table

The House of Representatives passed the Wall Street Reform and Consumer Protection Act in December 2009, and the Senate passed its version of the bill, Restoring American Financial Stability Act, on May 20. The two chambers of Congress will create a joint conference committee to reconcile the differences between the House and Senate bills. The Senate recently announced appointments to the committee (7 Democrats and 5 Republicans), all of whom are on either the Senate Banking Committee or the Agriculture Committee (jurisdiction over derivatives is shared between the Banking and Agriculture Committees). The House is expected to name its conferees in early June, with its members coming from the House Financial Services and Agriculture Committees.

The conference committee will begin discussions the week of June 7 after the Memorial Day recess, with the intention to present a final bill to the President before the July 4 holiday weekend. If committee members are unable to reach agreement by this summer, it lessens the chance of a reform package being passed by the current Congress, as the focus will shift to the upcoming November elections. Given the uncertainty surrounding the makeup of the next Congress and Senator Dodd's (Chairman of the Senate Banking Committee) retirement in November, there is incentive to pass the legislation before the August recess.

Legislative Timeline

Date	Action
December 11, 2009	House passed Wall Street Reform and Consumer Protection Act of 2009
May 20, 2010	Senate passed Restoring American Financial Stability Act of 2010
Estimated Dates	
May 31 – June 4	One week Memorial Day recess
June 8	Appointment of House and Senate Committee Members
First 3 weeks of June	Conference Committee reconciliation between Senate and House Bills
Week of June 28	House and Senate floor action
July 2	Administration and Congressional Democrat goal for enactment
July 5 – July 9	One week Independence Day recess
August 9 – Sept 10	August recess
November 2	U.S. mid-term elections

Regulatory Reform Conference Committee

Senate Conferees (Confirmed)

Senate named the following senators as Conferees on May 25, 2010 (7 Democrats, 5 Republicans):

Banking Committee	Agriculture Committee
Christopher Dodd (D-CT) Tim Johnson (D-SD) Jack Reed (D-RI) Charles Schumer (D-NY) Richard Shelby (R-AL) Bob Corker (R-TN) Mike Crapo (R-ID) Judd Gregg (R-NH)	Blanche Lincoln (D-AR) Patrick Leahy (D-VT) Tom Harkin (D-IA) Saxby Chambliss (R-GA)

House of Representatives Conferees (Tentative)

Expected to be 8 Democrats, 5 Republicans

Financial Services Committee *(recommended by Chairman Barney Frank)*	Agriculture Committee
Barney Frank (D-MA) Carolyn Maloney (D-NY) Paul Kanjorski (D-PA) Luis Gutierrez (D-IL) Mel Watt (D-NC) Maxine Waters (D-CA) Greg Meeks (D-NY) Dennis Moore (D-KS)	Expect additional conferees from Agriculture Committee and possibly other committees as well

Opinions expressed are as of May 2010 and are subject to change.

Congress is also working on a tax-focused bill that would extend certain laws that have either expired or have fast-approaching sunset clauses. The American Jobs and Closing Tax Loopholes Act (often referred to as the "extenders bill") primarily addresses items such as expiring unemployment benefits, but provisions have been added relating to defined benefit pension funding relief, taxation of carried interest in hedge fund and private equity partnerships, and fee disclosures for 401(k) plans. This bill is currently under active debate and likely to be passed by both chambers of Congress in early June.

Not all of the new proposed rules are being formulated in Congress or even inside the U.S. In the aftermath of the "flash crash" of May 6, the Securities and Exchange Commission (SEC) has already proposed new rules regarding circuit breakers that will be implemented very quickly. It is also considering regulatory changes affecting market structure, securitization and rating agencies. In January, the SEC adopted changes to money market funds that included more conservative investment parameters related to credit quality, maturity, liquidity and transparency to investors, and the SEC is in the process of reviewing additional structural changes to money market funds. In addition, the Department of Labor has issued guidance on target-date funds and has pending new regulations for both 401(k) participant disclosure and information required to be provided to plan sponsors. Finally, various European legislators and regulators are actively discussing issues ranging from the ability to sell hedge funds and private equity investments in the European Union to potentially banning the use of naked credit default swaps.

Positive Elements in the Various Proposed Rules

There are clearly some positive enhancements that will come about—or already have come about—from the new rules and regulations:

SEC rules on money market funds. Adopted in January, these changes have resulted in more conservative portfolios and greater liquidity to satisfy withdrawal requests in a time of stress, which was a key problem during the financial crisis. They have also helped to level the playing field and reduce the incentive to reach for incremental yield by taking on extra risk. While the tradeoff for these improvements is lower yields, we believe that the rules are a positive enhancement for money market funds.

Focus on ratings agencies. The ability for issuers to "shop around" and seek the highest ratings has come under tremendous scrutiny in the aftermath of the credit crisis. The proposed regulation seeks to mitigate conflicts of interest at rating agencies that earn their revenue from issuers of the securities they rate. The likely result is that this practice will be prohibited going forward, which will help to reduce conflicts of interest and improve the ratings marketplace. The Senate version of regulatory reform includes the creation of a bureau that will rotate rating assignments. If it survives to final passage, this too will reduce opportunities for ratings shopping.

Derivatives. The current proposals include requirements and incentives for increased standardization of swap contracts, increased collateral requirements, and a favorable move to centralized clearing when possible. Although the final details of these proposals will be worked out by the conference committee, these elements of derivatives reform have nearly across-the-board support and are therefore likely to be included in any final bill.

Municipal bonds. The SEC recently proposed enhanced disclosure rules for municipal bond issuers. In addition, the Senate version of the reform bill also seeks to provide the SEC with broader powers over the municipal market. Under the reform legislation, there will be greater transparency, more timely information, and stronger reporting requirements for issuers, all of which will benefit investors and improve the trading and liquidity of municipal bonds.

Hedge funds. We believe that the proposals requiring hedge funds to register with and report to regulators are appropriate measures, and industry opposition to this seems to have dissipated. We are in favor of increased manager disclosure and believe that public disclosure of aggregated anonymous data would provide useful information to market participants.

Pension funding relief. This provision, added to the "extenders bill", allows corporate and multi-employer defined benefit pension plans to amortize recent investment losses over 9 or 15 years. This is welcome news for many pension plans that had suffered losses during the downturn and can take advantage of these new terms.

Proposals that Raise Concerns

There are a number of proposals in the regulatory reform initiatives that raise concern as to how they might affect investment portfolios, capital markets, and most importantly, our clients:

Creditor rights issue. Creditor rights—at least for institutions that are determined to be systemically significant—are being moved out of the purview of bankruptcy courts to the Federal Deposit Insurance Corporation (FDIC) when it is appointed under the new Resolution Authority. Both House and Senate versions permit the FDIC to treat different bondholders in the same issue unequally. Permitting discrimination among bondholders is clearly a negative for capital markets and calls into question long-standing elements of contract law. If this provision survives, it is likely to increase financing costs for many companies. We have expressed our strong opposition to this proposal and would urge our clients to do the same.

Tier 1 capital definition. An issue that has received less coverage in the press is the potential for a rule change that would disallow Bank Trust Preferreds to count as Tier 1 regulatory capital. This emerged late in the Senate debate in an amendment proposed by Senator Collins. If this proposal goes through as drafted, we believe new issuance of Bank Trust Preferreds will cease, although it is likely that existing issues may be grandfathered in. This will effectively eliminate these securities, as there is no advantage to Bank Trust Preferreds if they are not considered as Tier 1 capital. We have internal task forces examining different possible scenarios so that we are prepared in advance of any changes to the Tier 1 definition.

Restrict the ability to use swaps in pension plans (and endowments). Although a good faith attempt to strengthen transparency and disclosure requirements, the proposal to apply "fiduciary" status to swap dealers raises concerns for pension clients. The unintended consequence of this provision is such that swaps will likely no longer be available to multi-employer public and private defined benefit and defined contribution plans, due to the concerns by dealers of the application of ERISA and similar state conflict of interest laws. While BlackRock and other managers have been actively lobbying to modify this proposal, we also urge our clients to raise objections and express concern about this important issue for pensions and endowments.

Defining book value wrappers as swaps. Book value wrappers are used in stable value funds and are highly customized bilateral agreements. Under current proposals, they would be defined as a swap transaction and would be subject to high capital requirements, making them prohibitively expensive. As issuers of book value wrappers are currently at or close to capacity, this could be somewhat of a death knell for the stable value product. DC plans and 529 plans that offer stable value products should be concerned about this potential development and should make it clear to decision makers that they want to continue offering this product to participants. We are working with a number of other managers of stable value products to express our concerns on this issue as well.

Fee disclosure in 401(k) plans. The House version of the "extenders bill" has language related to fee disclosures in 401(k) plans. This could affect managers and sponsors because it impacts the information managers must report to plan sponsors as well as the information sponsors must report to participants. In addition, this new language on fee disclosure has the potential to cause confusion, as the Department of Labor has already been working on new disclosure regulations for the past few years and is on the verge of making them final, possibly in June. While we do not have strong views on the specifics in either set of proposals, managers and plan sponsors are seeking clarity as to which set will eventually be executed. We hope to avoid wasting clients' time and money in implementing changes to comply with regulations that could soon become moot.

Volcker rule. This rule would restrict banks from making certain kinds of investments if they are not on behalf of their customers, and could result in spinoffs and the winding down of private equity units. Holders of private equity should note that this could adversely affect private equity valuations over the short term. However, there may be a silver lining over the long term in the form of less competition and more investment opportunities. We believe that some form of this rule will make its way into the final legislation.

Carried interest tax. There is a proposal in the House version of the "extenders bill" to raise the effective tax rate on carried interest paid to fund managers. The current language would increase the tax rate from 15% to around 35%, with a formula where 75% of income would be taxed as ordinary income and the remainder would be taxed at the 15% capital gains tax rate. Although it clearly has implications for private equity and capital formation, we believe this proposal will ultimately be approved given the need to find additional sources of revenue to help trim the budget deficit.

Potential downgrade of financial services firms. With growing opposition to treating any bank as "too big to fail" in the future, ratings agencies had indicated that they may downgrade a number of financial services firms, which would have negative implications on their funding costs. On May 25, Standard & Poor's issued a press release reversing its course on the threat to downgrade banks until they are able to analyze fully the final legislation and its implementation. S&P said it may not need to downgrade these large banks should Congress pass legislation that removes the "extraordinary government support" that has propped up their credit ratings. It also stated that full evaluation of the legislation could last through the end of the year and potentially into early 2011. We have formed a number of internal task forces to examine these proposals and begin working on the operational aspects of different outcomes so that we are prepared for these potential changes.

Mortgage and foreclosure mitigation. One major area that the various reform proposals surprisingly do not address is the mortgage sector. Although the Federal Reserve's agency debt and mortgage buyback programs were wound down successfully, any discussion regarding the role and future of Fannie Mae and Freddie Mac has been delayed until 2011. This is likely due to a reluctance to end the subsidy of housing, especially as these two housing agencies are currently being used to absorb losses resulting from loan modifications under the Home Affordable Modification Program (HAMP).

Looking Ahead

We support financial reform that increases transparency, protects investors and facilitates the responsible growth of capital markets. There are many positive elements in the proposals being debated in Congress and by regulatory agencies such as the SEC. However, we have concerns over certain issues, which, unless modified, may ultimately result in more harm than good for the financial system and our clients. We are actively involved in raising our concerns with decision makers in Washington with a strong focus on the impact on investors. We encourage our clients to engage in this process and to be vocal on the issues that are important to them. We will continue to keep you apprised of our efforts and of any new developments as the debate over regulatory reform continues.

Ways to Get Involved

- Submit letters to key members of the joint Senate and House conference committee
- Submit letters to your home state Senators and Representatives
- Co-sign letters with other involved parties
- Engage trade associations and firm lobbyists
- Join BlackRock for relevant meetings in Washington
- Reach out to your account manager if you are interested in becoming more active

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