OCTOBER 2012

The presidential race tightened in October before it was essentially put on hold by the weather. President Obama and Republican nominee Mitt Romney found themselves in a stalemate in national polls following three debates between them and one between the vice presidential candidates. Obama, though, appeared to maintain an Electoral College edge with leads in several key swing states. Just a week before Election Day, however, Hurricane Sandy shut down much of the East Coast and led to Obama and Romney suspending their campaigning for a few days.

ISSUES AND EVENTS

Two Democratic Senators Push for Completion of Volcker Rule; S&P Puts Possible $10B Annual Price Tag on Measure

The two Democratic senators most responsible for inclusion of the Volcker Rule in the 2010 Dodd-Frank Act told regulators in an Oct. 25 letter that the final regulations to implement the rule "should be issued without delay and no later than the end of the year."

Among the many provisions of Dodd-Frank, one of the most controversial is the Volcker Rule, which would generally prohibit banks from engaging in proprietary trading. Sens. Carl Levin, D-Mich., and Jeff Merkley, D-Ore., led the push to include the rule, arguing that it was needed to prevent the conflicts of interest and excessive risk-taking that they say contributed to the financial crisis. The rule was to have been implemented in July, but regulators, after releasing a much-criticized draft in October 2011, missed that deadline.

Published reports in late October indicated that a rift has emerged between the Securities and Exchange Commission (SEC) and three banking regulators about how to define market-making activities and the ability of banks to invest in hedge funds and certain other outside vehicles.

"While American families and businesses should be enjoying the protection of the Volcker Rule, your agencies' ongoing failure to implement these important protections has left them and our economy at greater risk of another financial crisis," Levin and Merkley wrote. "While we are cautiously pleased to see reports that a consensus is emerging, we are concerned that some ongoing staff-level differences may be obstructing progress. The time for resolving those differences is long overdue. We urge you to move quickly, make the final adjustments needed to simplify and strengthen the October 2011 proposal, and bring the process to a conclusion."

Business interests and Republicans have fought against the rule, arguing that it will be bad for the economy. Standard & Poor's released a report recently in which it estimated that a strict Volcker Rule could reduce combined pretax earnings of the nation's eight largest banks by as much as $10 billion annually.

"A stricter rule could hurt these institutions' business positions and have a broader impact across several other firms," the report stated. "Its international reach is also subject to debate. Specifically, declining trading volumes and shifting client relationships could affect the stability of these banks' businesses, which we'd factor into our business position assessments. In addition, a stricter outcome could lead to a substantial reduction in earnings, though we do not expect the Volcker Rule, regardless of its final determination, to change our assessments of banks' capital and earnings."

S&P added, though, that "the implementation of the Volcker Rule could have favorable implications for the credit profiles of some of the largest U.S. banks, such as reducing trading portfolio risk. This risk mitigation could lessen revenue and earnings volatility, which we would view favorably in our business position analysis."

The Levin-Merkley letter was sent to the heads of the SEC, the Federal Reserve, the Federal Deposit Insurance Corporation, the Comptroller of the Currency and the Commodity Futures Trading Commission.

Competing Reports Issued on Dodd-Frank and 'Too Big to Fail'

The 2010 Dodd-Frank Act either "effectively ends 'too big to fail' and specifically outlaws future taxpayer bailouts of a failing financial institution," or it "most certainly did not end bailouts; instead, it institutionalized them and made them permanent," depending on which of two reports released within days of each other in October by members of the House Financial Services Committee is consulted.

The federal government provided hundreds of billions of dollars in financial assistance to several large financial firms – most notably through the Troubled Asset Relief Program (TARP) – that were considered to be "too big to fail" during the recent financial crisis. Though most if not all of the aid has been recovered, the move remains unpopular and opinions are sharply divided about what effect the financial regulations reforms contained in Dodd-Frank will have when the next large, interconnected firm is about to fail.

The committee's ranking Democrat, Barney Frank of Massachusetts, one of the chief writers of the legislation the bears his name, issued a report that concludes that Dodd-Frank contains provisions that ensure that "a failing financial firm can fail in a fashion that minimizes risks to the financial system without any ultimate cost to taxpayers." The law, according to the report, improves risk management procedures to make firms less likely to fail and provides regulators with a new set of tools to wind down failing firms should that become necessary.

"To address the rare situations in which the operations of a nonbank financial company or bank holding company are too complex or important to go through bankruptcy without significantly disrupting the entire financial system, the Wall Street Reform and Consumer Protection Act provides a new Orderly Liquidation Authority as an alternative path to failure," the report states. "Having such an alternative ensures that the government never again will face the choice that it did in 2008 between propping up a failing firm or letting it fail at the risk of unacceptable systemic consequences."

In the procedure established by Dodd-Frank, the FDIC would be appointed as a receiver and would be required to liquidate the firm within five years. The report states that, "Claims that taxpayers will bear the cost of an Orderly Liquidation … are not based on the statute," since the FDIC and the United States government would be first creditors in line to collect proceeds from the liquidation.

Committee Chairman Spencer Bachus, R-Ala., however, released a report that insists that, "if we judge the Dodd-Frank Act on whether it 'ends too big to fail' and whether it 'ends bailouts,' we have no choice but to conclude that the Dodd-Frank Act is a failure."

"The largest financial institutions in America remain 'too big to fail'; in fact, they are even bigger now than they were at the height of the crisis," according to the report. "American taxpayers are no better protected against bailouts than they were in 2008: if anything, they are even more exposed to the danger that government bureaucrats will pick their pockets to bail out the creditors of the next 'too big to fail' institution that finds itself on the brink of failure."

The report maintains that "nobody" really believes that Dodd-Frank ended too big to fail, quoting, by way of example, Treasury Secretary Timothy Geithner as saying, "In the future, we may have to do exceptional things again if we face a shock that large."

The report rejects arguments that the law will allow the FDIC to liquidate failing firms, noting that while that agency has been successful in taking over relatively small banks, firms such as Citigroup and Bank of America are much larger than the institutions with which the FDIC has experience. It cites the example of 80 FDIC employees spending three days "resolving" a bank with $440 million in assets, then quotes a 2009 *Economist* article: "Most of the largest banks in trouble right now—Citibank, Bank of America – are about 6,000 times the size of Bank of Clark County, not to mention much, much more complicated. For those who don't have calculators handy, 80 multiplied by 6,000 is 480,000. On the bright side, that's one hell of a stimulus opportunity."

The report further states that Dodd-Frank authorizes the FDIC to borrow massive sums – trillions of dollars, potentially – from the Treasury Department as part of the resolution process.

"And make no mistake: that's *your* money," the report states. "The FDIC can borrow it from the Treasury, and the Treasury is you. The proponents of the Dodd-Frank Act say that you will be paid back. Let's hope that you are. But the bottom line is that it is *your* money, and you bear the risk."

Republican Lawmakers Step up Criticism of CFTC

Four House Republicans in October accused the CFTC of pursuing "ideological and political goals" in its implementation of derivatives trading rules.

House Financial Services Committee Chairman Spencer Bachus, R-Ala., and three other GOP committee members charged in an Oct. 10 letter to Commodity Futures Trading Commission (CFTC) Chairman Gary Gensler that the agency has been implementing rules that are "unrelated to the financial crisis and not required by Congress, which are draining its resources."

The congressmen focused on the "position limits" rule, which they said was indicative of the commission's "inability to adhere to the law." The CFTC adopted the measure in 2011 to cap the number of derivatives contracts a trader could hold on 28 commodities as a way to discourage speculative trading – which some say drives up prices of certain items – but it was struck down on Sept. 28 by a federal judge who determined that the agency "fundamentally misunderstood and failed to recognize the ambiguities in the statute." The case turned on whether Congress, in the 2010 Dodd-Frank financial regulations reform legislation, directed the commission to implement the rule or instructed the agency to do so only if it determined that such action was needed.

"The Commission's limited financial resources spent promulgating and defending the Position Limits Rules demonstrates a serious mismanagement of the agency's priorities," the congressmen wrote.

Gensler said on Oct. 10 that "Congress mandated us to do this," and he added that he supports appealing the ruling.

In addition to Bachus, the letter was signed by committee Vice Chairman Jeb Hensarling of Texas and two subcommittee chairmen, Randy Neugebauer of Texas and Scott Garrett of New Jersey.

Baucus, Garrett and two other members of Congress wrote to Treasury Secretary Timothy Geither on Oct. 5 to say that "widespread confusion and uncertainty exists" regarding soon to be implemented derivatives rules and to criticize the CFTC for what they said was a flawed rule-making process that, among other things, neglected coordination with the Securities Exchange Commission (SEC) and regulators in other nations.

Sen. Pat Roberts, R-Kan., meanwhile, sharply criticized Gensler and the CFTC's ongoing derivatives rulemaking on Oct. 12, saying that, after the position limits ruling, "we brace ourselves for the results of new regulations meant to bring transparency to the market that have in reality brought confusion, concern and do not inspire confidence in the CFTC's leadership."

"Unfortunately, it's my view that CFTC Chairman Gary Gensler is using his newfound power to unilaterally impose his will on financial markets," said Roberts, the ranking member of the Senate Agriculture, Nutrition and Forestry Committee. "Most distressing is that while Mr. Gensler has tried to create his regulatory agenda, he and the CFTC have miserably failed in their oversight of existing regulations and market participants. … The CFTC chairman's regulations-looking-for-a-problem method of rule writing is creating confusion and costing businesses a fortune in compliance costs."

Obama Backs Executive Pay Reform

Reforming executive pay is "the single biggest thing that I would like to see" in terms of additional financial reform after the 2010 Dodd-Frank Act, President Obama said in an interview published in late October.

In an article in ***Rolling Stone***, Obama was asked if he "could single-handedly enact one piece of regulation on the financial industry, what would it be?"

"I will tell you, the single biggest thing that I would like to see is changing incentives on Wall Street and how people get compensated," Obama said. "That ultimately requires not just congressional legislation but a change in corporate governance. You still have a situation where people making bets can get a huge upside, and their downsides are limited. So it tilts the whole system in favor of very risky behavior. I think a legitimate concern, even after Dodd-Frank, is, 'Have we completely changed those incentives?'"

The president went on to reiterate that making such a change may be less a matter of legislation than corporate governance.

"These days, you've got guys who are making five years of risky bets, but it's making them $100 million every year," he said. "By the time the chicken comes home to roost, they're still way ahead of the game. So I think it's something that needs to be discussed. But that's not something that can entirely be legislated – that's something that also has to involve shareholders and boards of directors being better stewards of their institutions."

Obama also responded to critics who say that Dodd-Frank should have separated commercial banking and investment banking, as Glass-Steagall did until 1999.

"There is not evidence that having Glass-Steagall in place would somehow change the dynamic," he said. "Lehman Brothers wasn't a commercial bank, it was an investment bank. AIG wasn't an FDIC-insured bank, it was an insurance institution. So the problem in today's financial sector can't be solved simply by reimposing models that were created in the 1930s.”

CII Advocates for Majority Election of Unopposed Director Nominees

The Council of Institutional Investors (CII) wrote to the American Bar Association (ABA) and the Delaware State Bar Association on Oct. 25 to urge the groups to support majority election of unopposed corporate director nominees.

At most public companies, director nominees need only a plurality of votes to be seated, so an unopposed nominee is elected even if a majority of shareholders vote against him or her. In its pre-Halloween press release, CII playfully referred to directors who are elected in this manner as “zombie directors.”

“Thus, many U.S. public companies continue to follow an antiquated, or as some have described ‘truly bizarre,’ voting process whereby a director is elected or reelected ‘so long as she receives *any* votes in her favor, even if ninety percent or more the shareholders vote against her,’” CII wrote to the ABA.

The council asked the ABA’s Business Law Section’s Committee on Corporate Laws to amend the Model Business Corporation Act to require majority voting in director elections in which a candidate is unopposed. CII similarly asked the Delaware State Bar Association’s Council of the Corporate Law Section to propose majority voting amendments to the Delaware General Corporation Law. About half of all U.S. public companies are incorporated in Delaware.

“We believe the proposed revisions to the DGCL … reflect the fundamental right and desire of shareowners to have a meaningful voice in director elections, and strike the appropriate balance between board power and board accountability,” the council wrote in the Delaware letter.

Rate Reviews Slowing Insurance Premium Hikes: Kaiser

Reviews of proposed health insurance premium hikes seem to be slowing the increase in rates, according to a study released by the Kaiser Family Foundation.

The 2010 health care reform law requires that all proposed rate increases of 10 percent or more be reviewed by a state agency or, in the absence of a state review process, the Department of Health and Human Services.

Kaiser found in its examination of rate reviews that 20 percent of reviews resulted in a lower increase than had been proposed and that the rate increases that were implemented were about 20 percent lower than they would have been without the reviews – 5.4 percent compared to 6.8 percent.

In California, out of 65 submissions, 14 were lowered, rejected or withdrawn, and the average implemented rate increase of 9.3 percent was somewhat below than the average requested increase of 9.9 percent.

Some states already had rate review programs in place before the 2010 Patient Protection and Affordable Care Act, so Kaiser noted that not all of the reductions can be attributed to the law.

"However, there are reasons to believe that the ACA may have had an effect, even in states with review programs in effect before the ACA. For example:

- Greater transparency associated with requested premium increases may have encouraged some insurers to file more modest rate increases.

- Increased emphasis on rate review and transparency may have created an incentive for state regulators to apply greater scrutiny during rate review.

- Federal rate review grants provided to states enabled many states to enhance their rate review processes, for example, by hiring additional actuarial staff."

The study included 846 filings from 41 states and the District of Columbia.

Drug Makers Not Inflating Prices to Offset Required Discounts: GAO

The Government Accountability Office (GAO) found no data indicating that prescription drug manufacturers are inflating prices to make up for certain discounts that are required by the 2010 health care reform law.

The Patient Protection and Affordable Care Act included a provision that will close the "donut hole" in the Medicare Part D drug benefit by 2020 in addition to a requirement that manufacturers provide a 50 percent discount to beneficiaries who are in the coverage gap. There have been some concerns that manufacturers may raise prices more rapidly for drugs used by beneficiaries receiving the discount in order to offset the reduction.

GAO reported that most plan sponsors and pharmacy benefit managers believe the discount program can be linked to rising prices, but manufacturers deny it.

In looking at the data, GAO found that "prices for brand-name drugs used by beneficiaries in the coverage gap increased similarly to those used by beneficiaries who did not reach the gap, before and after the Discount Program was implemented in January 2011."

Between January 2007 and December 2010, the average price of the 77 drugs used by beneficiaries in the coverage gap increased by 36.2 percent, while the average for the 78 drugs used by those not in the gap rose by 35.2 percent. In the following year – the first year of the discount program – the average prices in both categories increased by about 13 percent. The results were similar even after the 50 drugs that overlapped both groups were removed.

The Department of Health and Human Services commented that GAO's findings were consistent with those of studies conducted by the Centers for Medicare and Medicaid Services (CMS).

Social Security Trust Funds to Be Empty by 2034: CBO

With annual expenditures now exceeding tax revenues, Social Security's trust funds will be empty by 2034, according to projections from the Congressional Budget Office.

Social Security spending is expected to exceed tax revenues by about 10 percent during the next decade and will surpass 20 percent by 2030 as more and more baby boomers retire, the CBO projects.

The 75-year shortfall for the program equals 1.95 percent of payroll.

Social Security trustees offered slightly different projections in April, forecasting the exhaustion of the trust funds by 2033 and putting the 75-year deficit at 2.67 percent of payroll.

RELATED NATIONAL AND INDUSTRY NEWS

100 Largest Public Pensions Face $1.2 Trillion Shortfall: Milliman

The latest study of public pension finances puts the unfunded liabilities of the 100 largest funds at $1.2 trillion.

The report from Milliman found that, using "current market values of assets and current views on investment returns," the funds have assets of $2.5 trillion and accrued liabilities of $3.7 trillion. The aggregate funding level was found to be 67.8 percent.

Using June 30, 2010, data, CalPERS was found to have assets with a market value of $202 billion and an actuarial value of $257 billion, with an accrued liability of $308 billion. This leads to a $51 billion shortfall and a funding ratio of 83 percent.

The numbers are similar to those reported by the plans themselves, and the report lauded the often-criticized projections used by public pensions.

"On the whole, we conclude that there are only a small number of plans whose interest rate assumptions are causing a sizeable underreporting of liability relative to what would be calculated based on current forecasts of future investment returns; in fact, there are a surprising number of plans whose interest rate assumptions and accrued liability reporting are conservative in light of current forecasts," the report states.

Milliman did not identify which plans were considered to be underreporting their liabilities.

Only two of the 100 plans were found to have surpluses: the New York State Teachers' Retirement System ($225 million) and the Washington State Law Enforcement Officers' and Fire Fighters' Plan 1 and 2 ($2.3 billion).

Unfunded Pension Liabilities Equal $1,385 Annual Tax Increase per Household, Academics Write

Two leading academic critics of public pensions argued in the *Washington Post* on Oct. 19 that "states are digging deeper holes each year" by not dealing with pension funding issues.

Robert Novy-Marx of the University of Rochester's Simon Graduate School of Business and Joshua Rauh of the Stanford Graduate School of Business and the Hoover Institution have published several papers – most recently in September – in which they warned of dire consequences unless major reforms are made to public pensions. Their research is frequently used by proponents of transitioning public employees from their current defined benefit pensions into defined contribution accounts. Their methodology, though, has been criticized by members of the public pension community.

In order to cover unfunded pension liabilities, Novy-Marx and Rauh wrote that taxes would have to be raised immediately by $1,385 per household per year, with that amount growing in proportion to the increase in the size of the public sector. (Their projected tax increase for California is $1,994 per household.) Alternatively, they noted, budget cuts could be made to reduce or eliminate this tax hike.

The conclusions are based on an assumed investment return of 2 percentage points above inflation, well below both the 8 percent projection that is commonly used by the plans and the funds' historical rates of return. This is the primary criticism that Novy-Marx and Rauh make regarding public pension plans in their writings, that the funds use a discount rate that is too high and that masks the size of their liabilities. Instead, the authors – and other critics – have said, funds should use a "riskless" rate of projected return when performing calculations, such as the 4 percent or so that would be expected from U.S. Treasury bonds. Public sector representatives, though, have noted that, notwithstanding the occasional bear markets, the funds' projections over the long term have proven to be reasonable. Nonetheless, not even solid investment returns will cover all of the future costs, according to Novy-Marx and Rauh.

"But even if states continue to make massive bets that the stock market will bail them out, and if the market were to perform as well over the next 30 years as it did over the past half-century (an unprecedented bull market), the required per-U.S. household tax increase would still amount to $756 per year," they wrote.

The authors suggested a set of "forward-looking reforms" that include introducing hybrid plans that combine 401(k)-type accounts with a defined benefit component, reexamining cost-of-living adjustments and considering new plan designs.

"The bottom line is that, as long as government accounting standards allow systems to justify low contribution levels by using optimistic guesses about returns that can be earned on portfolios of risky assets, traditional public-employee defined-benefit plans will generate more and more debt," they wrote. "And without reform, the eventual cost of funding these plans will, someday, make the $1,385 per-household increase required today seem cheap."

Public Sector Groups Draft Pension Funding Guidelines

A task force that comprises 11 public sector groups in October released a set of pension funding guidelines.

The task force was convened by the Center for State and Local Government Excellence to provide guidance for public pension funding decisions in the wake of new rules announced by the Governmental Accounting Standards Board (GASB) in June. The outgoing rules defined the annual required contribution (ARC), which was interpreted by many as the funding standard, but the new rules do not do so. In response, the groups established five objectives to determine pension funding:

- **Actuarially Determined Contributions.** A pension funding plan should be based upon an actuarially determined ARC that incorporates both the cost of benefits in the current year and the amortization of the plan's unfunded actuarial accrued liability.

- **Funding Discipline**. A commitment to make timely, actuarially determined contributions to the retirement system is needed to ensure that sufficient assets are available for all current and future retirees.

- **Intergenerational equity**. Annual contributions should be reasonably related to the expected and actual cost of each year of service so that the cost of employee benefits is paid by the generation of taxpayers who receives services from those employees.

- **Contributions as a stable percentage of payroll**. Contributions should be managed so that employer costs remain consistent as a percentage of payroll over time.

- **Accountability and transparency**. Clear reporting of pension funding should include an assessment of whether, how and when the plan sponsor will ensure sufficient assets are available for all current and future retirees.

The new standards from GASB, which are to be implemented in 2013 and 2014, will, for the first time, require governments that provide defined benefit pensions to employees to report pension promises as liabilities. The rules will allow funds that are financially healthy to continue to use a discount rate that reflects "the long-term expected rate of return on plan investments" in calculating their "net pension liability." Critics of public pensions have pushed to require funds to use a "risk-free" rate of return – as would be expected from Treasury bonds – for the discount rate, which would be about half of the 8 percent return that is now commonly projected.

Funds may continue with the current discount rate method, however, only "as long as the plan net position is projected under specific conditions to be sufficient to pay pensions of current employees and retirees and the pension plan assets are expected to be invested using a strategy to achieve that return." Pensions in poorer fiscal condition must use a discount rate that is more like the riskless rate that critics support, specifically, "a yield or index rate on tax-exempt 20-year, AA-or-higher rated municipal bonds."

The groups participating in the task force include members of the "Big 7" – the National Governors Association, the National Conference of State Legislatures, the Council of State Governments, the National Association of Counties, the National League of Cities, the U.S. Conference of Mayors, and the International City/County Management Association – plus the Government Finance Officers Association, the National Association of State Retirement Administrators, the National Council on Teacher Retirement, and the National Association of State Auditors, Comptrollers and Treasurers.

California Congressional Delegation News

Calif. Rep. Concerned about Commodity Investments by Private Pensions

A California congressman on Oct. 25 wrote to the Department of Labor to express concerns about investments by private sector pension plans in commodity index funds.

Rep. George Miller of California, the ranking Democrat on the House Education and the Workforce Committee, and Rep. Ed Markey of Massachusetts, the ranking Democrat on the House Natural Resources Committee, first wrote to the department in April to ask about pension investments in such funds and "the implications for those investments under the Employee Retirement Income Security Act of 1974." Critics argue that speculation, in some cases through commodity index funds, is driving up the costs of gasoline, home heating oil and other goods, and Miller and Markey have said they fear that such funds are risky investments for pensions since they may be part of a "commodity bubble" that the congressmen have likened to sub-prime mortgage investments during the 2000s.

Department officials replied to the April letter by saying that they are unable to answer a question that was asked by Miller and Markey – whether any of the 10 largest private pension plans have 1 percent or more of their assets invested in commodity index funds – since many assets are held in a "master trust" or similar vehicle, and the regulatory filings for such trusts do not allow for the capture of data that would provide that information.

Miller and Markey wrote in the most recent letter that they "do not believe the present situation is suitable for pension plan participants or investors generally."

"As we laid out in our April 25, 2012 letter, commodity index funds are a potentially dangerous investment for pension plan participants and beneficiaries; they have poor investment performance, increase volatility in commodities markets, and increase the prices of commodities," they wrote. "If the Department of Labor does not have ready access to information about pension plan investments in these funds, it is unclear how the Department would know whether it must take additional regulatory action to protect workers and retirees from these risky investments."

Miller and Markey closed by asking additional questions about the possibility of capturing the requested data.

4 GOP Reps Seek Suspension of Electronic Health Records Incentive Program

Saying that the federal incentive plan that pays health care providers to transition to electronic health records "appears to be doing more harm than good," four leading House Republicans, including one from California, are urging that the government suspend the program.

House Ways and Means Committee Health Subcommittee Chairman Wally Herger of California and three GOP colleagues wrote to Health and Human Services (HHS) Secretary Kathleen Sebelius on Oct. 4 to "express serious concerns" about the incentive program, particularly the recently issued Stage 2 rules that are intended to ensure "meaningful use" of digital records. These guidelines, they wrote, are "in some respects, weaker" than the Stage 1 rules that were issued in 2009, and will result in "a less efficient system that squanders taxpayer dollars and does little, if anything, to improve outcomes for Medicare."

"The Stage 2 rules fail to achieve comprehensive interoperability in a timely manner, leaving our health care system trapped in information silos, much like it was before the incentive payments," they wrote. "More than four and a half years and two final Meaningful Use rules later, it is safe to say that we are no closer to interoperability in spite of the nearly $10 billion spent."

The congressmen went on to reference recent reports that the implementation of electronic health records has increased Medicare costs.

They urged Sebelius to suspend the incentive program "until your agency promulgates universal interoperable standards"; to increase the meaningful use requirements; and to "eliminate the subsidization of business practices that block the exchange of information between providers."

The other three signers to the letter were Ways and Means Committee Chairman Dave Camp of Michigan; Energy and Commerce Committee Chairman Fred Upton of Michigan; and Energy and Commerce Committee Health Subcommittee Chairman Joe Pitts of Pennsylvania.