

# House-Senate Conference Negotiations on Financial Reform

## A Score Card for Tracking Key Differences And Likely Outcomes

June 7, 2010



## *What Will the Key Financial Regulatory Reform Changes Look Like Coming out of the House-Senate Conference Committee on Financial Reform?*

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*Both the House and Senate versions create a council of regulators to monitor systemic risk and require stricter capital and other prudential requirements for financial firms determined to be “systemically important.” The Fed has the central role in determining stricter standards for bank holding companies, but the council can ban specific activities or practices that pose specific systemic threats.*

House Passed	Senate Version	Likely Outcome
<p><b>Membership:</b> Systemic Risk Council (FSOC) 10 Members (Treasury (chair), Fed (vice-chair), FDIC, OCC, SEC, CFTC, FHFA, New consumer head, NCUA, and new Treasury insurance office head)</p>	<p>Systemic Risk Council (FSOC) 9 Members (Treasury (Chair), Fed (vice-chair), FDIC, OCC, SEC, CFTC, FHFA, New consumer head, and insurance expert appointed by President)</p>	<p>Senate version more likely, but with likely inclusion of head of NCUA and other non-voting members (such as new Treasury Office of Financial Research and state insurance and banking representatives)</p>
<p><b>Scope:</b> Broad range of almost all financial companies that could be subject to systemic risk designation by simple FSOC majority vote</p>	<p>Senate requires 2/3 vote (including Chair) for nonbanks and the Fed would decide which bank holding companies over \$50 billion are covered, plus Vitter amendment that excludes companies with less than 85% of consolidated assets involved in traditional financial business</p>	<p>Senate gap of financial companies under \$50 billion likely to be removed, but 85% level of financial business likely to stay (though it might be lowered by to 75%)</p>
<p><b>Required prudential standards</b></p> <ul style="list-style-type: none"> <li>•Risk-based capital requirements (Must be countercyclical and include off-balance sheet items)</li> <li>•Leverage requirements (15 to 1 required)</li> <li>•Liquidity requirements</li> <li>•Concentration limits (generally 25%, but exempts home loan banks)</li> <li>•Prompt corrective action requirements</li> <li>•Overall risk management requirements</li> <li>• Periodic “stress tests” and living wills will be required</li> </ul>	<p>Required prudential standards</p> <ul style="list-style-type: none"> <li>•Risk-based capital requirements (No specific mention if must be countercyclical and include off-balance sheet items)</li> <li>•Liquidity requirements</li> <li>•Concentration limits (generally 25% with no exemption for home loan banks)</li> <li>•Prompt corrective action requirements</li> <li>•Periodic “stress tests” and living wills will be required.</li> </ul> <p><i>Collins Amendment: Requires bank holding companies to follow bank-level tier one capital requirements (therefore excluding TRUPs and hybrid securities)</i></p>	<p>Required prudential standards likely will be much closer to Senate version (but will include House language exempting home loan banks), and will have the following optional standards:</p> <ul style="list-style-type: none"> <li>•Contingent capital (long-term debt with preset conversion criteria after Fed Study)</li> <li>•Asset sales or break-ups (if determined to pose systemic threat)</li> <li>•Other prudential standard established by regulators to mitigate systemic risk</li> </ul> <p><i>Collins amendment likely to at least be amended to grandfather current TRUPs and hybrid securities, and possibly allow them to remain eligible subject to outcome of Basel III negotiations to determine new tier one requirements for all international banks</i></p>

House Passed	Senate Version	Likely Outcome
<p><b>Volcker Rule -- Prop Trading Ban:</b> No bright-line ban in House version, but instead a case-by-case finding of systemic threat would be required before any prop trading ban would be imposed</p>	<p>Prop trading ban only after GAO and FSOC studies, and regulators could adjust implementation accordingly --but without ability to reject basic elements of the ban on prop trading (however defined) and to ban mergers if the total consolidated liabilities exceed 10% of all companies</p>	<p>House conferees will propose amending Senate Volcker language with more prescriptive Merkley-Levin language, folding in derivatives prop trading ban, but with some more prescriptive exemptions as well that would allow own funds for asset management, and insurance investments</p>
<p><b>Derivatives Push-out:</b> Not included in the House version</p>	<p>Sec. 716 derivatives push-out provision – which denies access to discount window for all bank holding companies that trade derivatives (though some interpret language to allow trading to continue in a separately capitalized subsidiary)</p>	<p>Likely to be dropped, but with Sen. Lincoln as a key conferee vote in a seven-to-five ratio of Senate conferees, will be finessed by “folding her section 716 language into the Volcker language, which will specify derivatives trading as part of the ban on prop trading</p>
<p><b>Payment System:</b> The House version of the payment, clearing and settlement title was removed at the committee level pursuant to an amendment offered by Rep. Biggert, who was working with CME and other CFTC regulated entities that want to remain solely under the jurisdiction of the CFTC.</p>	<p>Comprehensive new payment, clearing and settlement (PCS) powers for the Federal Reserve, with ability to establish risk management standards for all bank PCS activities and third party PCS companies, such as wholesale and retail payments, securities and derivatives clearing utilities, etc. -- Fed authorized to give access to discount window for all systemically important financial market utilities</p>	<p>A key systemic risk decision is needed to determine whether the Fed or the CFTC/SEC will be responsible for monitoring the systemic risks posed by the new derivative clearinghouses (and other PCS companies), and while it’s a close call, Cap Alpha believes that the Federal Reserve (with the backing of Treasury Secretary Geithner) will ultimately be the risk supervisor of the PCS’s (though it may share systemic supervision over the new clearinghouses with the CFTC/SEC)</p>
<p><b>Additional Fed Powers:</b> Systemically important banks and nonbanks regulated “as if” bank holding companies, and new systemic standards may be imposed at the foreign parent level (taking into account home-country supervision) and ability to deny (or terminate) US subsidiary of foreign firm’s access to US markets if inadequate parent supervision</p>	<p>Fed regulates all bank holding companies and systemically important financial institutions, but nonbank FIs do not need to move all assets into separate financial holding company, and no explicit authority to deny US subsidiary of foreign financial firm access to US market if home country lacks sufficient systemic risk supervision</p>	<p>Largely the Senate version with the Fed retaining jurisdiction over BHCs, state member banks, plus supervisory power over all systemically important financial companies – but with House language providing ability to deny (or revoke) access to US markets to US subsidiaries of foreign companies if home country risk supervision found to be inadequate</p>

# New Limits on Future Financial Stability Programs

*Both versions place significant limits on future Federal Reserve emergency lending facilities and FDIC debt guarantee programs, making future “bail outs” less likely and without the ability to provide assistance specifically to one firm.*

House Passed	Senate Version	Likely Outcome
<p><b>FDIC Emergency Powers:</b> Future FDIC loan guarantees limited to (\$500B) with 2/3 vote of FSOC and Treasury concurrence</p> <p>Congressional approval only required beyond \$500 billion cap</p>	<p>New FDIC guarantee authority, but more specificity on need for programs to be “widely available” only to healthy banks</p> <p>Congressional approval would always be required</p>	<p>Senate version likely to prevail with emphasis on limiting programs to those “widely available” and only to healthy banks</p> <p>Congressional approval always required and no \$500 billion cap</p>
<p><b>Fed Emergency Powers:</b> Future Fed 13(3) emergency lending powers limited to \$4T general assistance with Treasury approval based upon written finding that a destabilizing liquidity problem exists, and fed would have to find that private assistance not available and collateral is sufficient with 99% certainty</p> <p>Congress would have ability to issue a joint resolution of disapproval</p> <p>Requires a GAO audit of the Federal Reserve Board and the Reserve Banks, including monetary policy deliberations, open market and discount window operations, FOMC transactions, and foreign central bank transactions – but Excludes unreleased minutes/transcripts of FOMC meetings.</p>	<p>Fed 13(3) emergency lending powers limited to “financial market utilities” deemed systemically important by FSOC or to programs or facilities that are “broad-based” in nature -- not benefiting any specific firms, with specific criteria forcing the Fed to only accept high quality collateral</p> <p>Emergency programs or facilities must be approved by Treasury and reported to Congress within 7 days (no special procedures for joint disapproval resolution)</p> <p>GAO authorized to audit current and future emergency lending facilities, and Fed must publish the recipients of all current 13(3) programs with the terms of assistance provided</p>	<p>Will likely follow the stricter Senate language regarding emergency 13(3) powers, which was Ranking Member Shelby’s principal request in order to support moving the bill out of committee</p> <p>Going forward, access to 13(3) emergency lending will be limited to “financial market utilities” or to “broad-based” facilities that do not benefit a single company, with Treasury approval and congressional notification and GAO audit</p> <p>Federal Reserve likely to win its fight to avoid intrusive scrutiny of its monetary policy actions, though a full accounting of emergency financial assistance provided to specific firms will be required</p>

# New FDIC “Systemic” Resolution Authority and Funding CAPITAL ALPHA PARTNERS LLC

*Both versions establish bankruptcy as the default insolvency regime, with FDIC resolution only in rare cases authorized by the FSOC and Treasury, with dissolution/receivership the only option (no conservatorship allowed). Shareholders and unsecured creditors must bear losses and any “culpable” executives must be replaced. FDIC provided similar powers to receivership of a bank, but in case of the holding company level, new powers given to address financial contracts, and the need to protect systemic stability.*

House Passed	Senate Version	Likely Outcome
<p><b>Secured Creditor Haircuts:</b> Limited to 10% and short-term secured lending (30 days or less) and, 1) the collateral is not government-issued securities, and 2) no funds from unsecured creditors or shareholders is available</p>	<p>There is no similar Senate provision requiring a secured creditor haircut, but prohibits taxpayer funds from being used to prevent the liquidation of a systemically important financial firm</p> <p>Allows for unequal treatment of creditors if it maximizes assets of failed firm, aids in operation of bridge company or helps FDIC minimize its losses.</p>	<p>Senate version likely to prevail, leaving no specific secured creditor haircut mandate in the final version, and the FDIC would likely still have the discretion to discriminate within the same class of creditors (as long as it can demonstrate that creditor would not have done any better in unassisted bankruptcy)</p>
<p><b>Funding:</b> Ex-ante \$150B fund from risk-based assessments, but with borrowing authority if needed.</p> <p>FDIC authorized to determine how to assess banks for repayment</p>	<p>Ex-post funded – First the fund would borrow from Treasury and if liquidation recovery proves insufficient, then “preferential payments could be clawed back,” with last option being an assessments on all financial institutions above \$50 billion (using higher rates for those with larger and riskier assets)</p>	<p>Senate ex-post version likely to prevail, including Senate claw back language if FDIC later determines that a creditor was treated better than pure bankruptcy</p> <p>Will likely be left unclear how banks will be assessed in future crises</p>
<p><b>Coverage:</b> House has very broad coverage of financial firms potentially subject to “systemic resolution” except credit unions</p> <p>Insurance companies will be liquidated or rehabilitated following state laws, but systemically important insurance holding companies subject to new FDIC regime</p>	<p>Senate would exclude nonbank financial companies that do not meet the 85% financial revenue test required to be deemed systemically important</p> <p>Insurance companies treated similarly as in the House version</p>	<p>Senate version likely to prevail as GE and other large companies with some financial activity have successfully lobbied the Senate, though some chance the House and Treasury will insist on removing the 85% rule</p> <p>Only systemically important insurance company holding company will be included</p>
<p><b>Judicial Review:</b> House has no pre-receivership judicial process, but allows for later conversion to bankruptcy process</p>	<p>Treasury Secretary must obtain an order from US District Court to appoint FDIC as receiver, but not if board of the financial institution consents</p>	<p>Will require advance request by Treasury with approval by a federal court largely along the lines of the Senate version</p>

**Both versions would create a comprehensive regulatory regime to regulate all derivatives markets, participants and products. Both provide CFTC with great discretion to regulate mandatory clearing for an individual, group, category, type, or class of swaps, based on the six statutory factors:**

- The extent to which any of the terms of the swap agreement, including price, are disseminated to third parties or are referenced in other agreements
- The volume of transactions in the group, category, type, or class of swaps
- The extent to which the terms are similar to the terms of other swaps that are cleared
- Whether any differences in the terms are of economic significance
- Whether a derivatives clearing organization is prepared to clear the swaps and such derivatives clearing organization has in place effective risk management systems.
- Any other factors the Commission determine to be appropriate.

House Passed	Senate Version	Likely Outcome
<p><b>Mandatory Clearing:</b> Only applies to dealers and major swap participants (MSPs), with a two-part test to determine who are MSPs:</p> <p>1) If they maintain a <u>substantial net position</u> in outstanding swaps, excluding positions held primarily for hedging, reducing or otherwise mitigating its commercial risk; or</p> <p>2) if their outstanding swaps create <u>substantial net counterparty exposure</u> that could have serious adverse effects on the financial stability of the United States banking system or financial markets.</p> <p>CFTC/SEC to define the <u>operative terms</u></p>	<p>Creates a three-part test for determining who is an MSP:</p> <p>1) If they maintain a <u>substantial position in outstanding swaps</u> for any of the major swap categories as determined by the relevant Commission, excluding positions held for hedging commercial risk (or pensions mitigating risk associated with the operation of the plan); or</p> <p>2) If their outstanding swaps create <u>substantial counterparty exposure</u> that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or</p> <p>3) is a <u>financial entity that is highly leveraged</u> relative to the amount of capital it holds and maintains a substantial position in outstanding swaps (other than, for CFTC-regulated swaps but not SEC-regulated SBS, an entity predominantly engaged in providing financing for the purchase of an affiliate’s merchandise or manufactured goods)</p>	<p>Senate version of MSP, but with end user hedging for commercial end users, and allowing regulators discretion in defining the key terms, i.e. what is a “substantial position in outstanding swaps” and what constitutes “substantial counterparty exposure,” but third prong excluding most financial companies likely to be improved so that additional financial companies may be able to access the first two exemptions (not just captive financials)</p>

House Passed	Senate Version	Likely Outcome
<p><b>Mandatory Exchange Trading:</b> If cleared, derivatives must be executed via regulated exchange or regulated alternative swap facility (ASEF)</p>	<p>Similar Senate provision requiring cleared swaps to traded on a regulated board of trade or ASEF, but mandates that all “trading or processing” of swaps must be done via these two options.</p>	<p>The Senate’s more descriptive language likely to prevail, but some discretion may be left to the CFTC to allow a small subset of “cleared but not exchange-traded” swaps, and to define the regulatory and reporting requirements that ASEFs must meet.</p>
<p><b>Margin and Capital Requirements:</b> Banking regulators will set margin and capital requirements for banks that are dealers or MSPs, and the CFTC is authorized to ensure that exchanges set appropriate margin requirements that are “designed for risk management purposes in order to protect the financial integrity of transactions” and clearing organization itself, but may not set “specific margin amounts” itself.</p>	<p>Calls for banking regulators to establish minimum margin and capital requirements for banks that are swap dealers or MSPs, with capital requirements above zero for cleared swaps and “substantially higher” ones for non-cleared swaps -- gives regulators discretion in allowing for use of non-cash collateral to meet margin requirements.</p>	<p>A key systemic risk decision is needed to determine whether the Fed or the CFTC/SEC will be responsible for monitoring the systemic risks posed by the new derivative clearinghouses (and other PCS companies), and while it’s a close call, Cap Alpha believes that the Federal Reserve (with the backing of Treasury Secretary Geithner) will ultimately be the risk supervisor of the PCS’s (though it may share systemic supervision over the new clearinghouses with the CFTC/SEC)</p>
<p><b>Broker Dealer Fiduciary Duty:</b> Requires the SEC to issue regulations specifying that brokers must follow the same standard of care as investment advisers dealing with retail investors, but without “continuing duty of care”</p>	<p>The Senate version only has a study on the issue of broker’s duty to retail investor, but it imposes a fiduciary duty on swap dealers in transactions with state and local government agencies, pension funds and endowments.</p>	<p>SEC likely to be authorized to impose same standard for brokers as investment advisers when dealing with retail clients and to determine what suitability standards apply when swap dealers are working with local governments, pensions and endowments.</p>
<p><b>Derivatives Position Limits:</b> Requires the CFTC to impose position limits for certain markets and will have authority to impose them on OTC markets.</p>	<p>Authorizes position limits for swaps that perform a significant price discovery function and aggregate position limits (including related hedge exemptions) for each month across designated contract markets (or contracts that settle based on the price of such market – including foreign board of trade) as well as swaps traded on a swap execution facility (or if affect price discovery of such).</p>	<p>Should be close to section 737 of the Senate language, possibly with some greater specificity of what may or may not be allowed as a hedge exemption.</p>

House Passed	Senate Version	Likely Outcome
<p><b>Structure:</b> House version creates an independent agency with a single Director, but would become a five-member commission in two years, funded initially by the Fed, then assessments on banks (over \$10b) plus nonbanks and appropriations</p>	<p>A bureau in the Federal Reserve, but with complete autonomy in budget and personnel, with funding from Fed's earnings (no appropriations from Congress) FSOC can veto new rules by 2/3 majority</p>	<p>Senate version likely to win out as the prudential veto was a key compromise in the Senate, therefore 2/3 veto remains but less likely that the industry preferred Fed-only funding mechanism will remain, with appropriations/assessments possible outcomes</p>
<p><b>Coverage:</b> Broad <u>rule-making</u> authority over banks and nonbank financial institutions, including activities such as deposit-taking activities, extending credit, servicing loans, providing real estate settlement services, performing appraisals, money transmittal, check cashing, payday lending, credit reporting, debt collection, title insurance, rent-to-own, leasing agent, financial data processing, tax planning, etc.</p> <p>Banks &lt;\$10 billion remain under primary <u>examination and enforcement authority</u> of prudential regulators</p>	<p>Similar coverage for <u>rule-making</u>, but <u>examination and enforcement</u> by consumer regulator limited to</p> <ul style="list-style-type: none"> <li>•Mortgage providers including brokers, lenders, servicers and loan mod providers, and</li> <li>•Specific "larger participants" identified by consumer regulator via implementing regulations</li> </ul>	<p>Coverage of laws unlikely to change, but Senate version of exemptions from examination and enforcement likely to remain, as well as possibly the under \$10 billion exemption for small banks in the House version.</p> <p>Both bills authorize consumer regulator to issue regulations regarding student lending, and House bill gives consumer regulator broader discretion to supervise private schools (but unclear whether will be in the final bill)</p> <p>House language regarding mortgage consumer protections likely to be incorporated</p>
<p><b>Exemptions:</b></p> <ul style="list-style-type: none"> <li>•Merchants (unless they sell the loans), and</li> <li>•Auto dealers</li> </ul> <p>Student lending not exempt</p>	<p>Senate has exemption for merchant businesses limited to those "not significantly engaged" in offering consumer financial products, but auto dealers and student lenders not exempt</p>	<p>Senate version likely to remain, but blanket exemption for merchants likely to be watered down to include most that are engaged in significant amount of consumer financial credit business</p>
<p><b>Preemption:</b> OCC can only pre-empt to the extent that it determines (in consultation with the new consumer regulator) that substantial evidence exists that federal protections are "substantively equivalent"</p> <p>Courts not required to give traditional regulatory deference following the traditional <i>Chevron</i> standard</p>	<p>Re-establishes Barnett standard of pre-emption, whereby OCC could preempt state law if it "prevents or significantly interferes with the operations of a national bank" or if it discriminates against national banks</p> <p>State AG's empowered to enforce new federal rulings by the consumer regulator but CFPB can intervene and raise to federal court</p>	<p>Largely will follow Senate compromise on Barnett standard, state AG enforcement of new consumer regulator rulings, and new court deference standard requiring a court to assess the thoroughness of OCC's consideration, validity of its reasoning, consistency with other valid determinations</p> <p>However, likely won't include Senate's effective removal of preemption protection for subsidiaries of national banks and thrifts.</p>

House Passed	Senate Version	Likely Outcome
<p><b>Risk Retention:</b> Both bills require regulators to establish risk retention requirements for all types of securitized assets, with 5% as the base level but with some discretion to lower them or make first or last lost depending on the asset risk characteristics</p> <p>House version exempts VA, SBA, and Ag/Farm Credit loans</p>	<p>Senate bill has similar 5% risk retention requirement, but Landrieu amendment provides a safe-harbor for RMBS that meet safe mortgage underwriting standards to be issued by the prudential regulators.</p> <p>For CMBS, Crapo amendment allows regulatory alternatives to risk retention, including underwriting standards and controls, or via stronger representations and warranties.</p>	<p>Senate version likely to win out, in that RMBS “safe harbor” and CMBS underwriting standards or warranties alternatives are both likely to remain in the final version</p> <p>However, while the Senate version only exempts Farm credit, the final version is likely to add the exemptions for VA, SBA and Ag loans as well</p>
<p><b>Credit Rating Agency:</b> House version lowers the pleading standard to “gross negligence,” allows investors to recover damages, and eliminates their exemption from “expert liability” if rating included in a prospectus</p> <p>Prohibits same rating agency from providing rating and consulting services to same issuer</p> <p>Removes statutory requirement for banking and other regulators to rely on NRSRO for rating in determining creditworthiness</p>	<p>Senate bill has a slightly better “knowing and reckless” pleading standard and allows private right of action but not damages</p> <p>Conflict of interest prohibition limited to separating marketing of ratings and analytics</p> <p>Removal of statutory reliance limited to agencies under the jurisdiction of the banking committees</p> <p>Creates an SRO to assign initial structured product ratings to each rating agency, along with a requirement that the SRO determine what is a reasonable fee for such service</p>	<p>The Senate version of pleading standard (knowing and reckless) is likely to be in the final version, but it is unclear at this point if the House will accept the establishment of new SRO for initial structured finance ratings that would also have to determine what a reasonable fee is for such service</p> <p>The final version will more likely than not add the House language requiring removal of NRSRO references and possibly regarding private right of action as well</p>
<p><b>Executive Compensation:</b> Nonbinding vote on pay and termination payment</p>	<p>Nonbinding vote on pay -- not final payment</p> <p>Clawback of incentive-based comp if restatement due to material noncompliance with and financial reporting requirements</p>	<p>The final version will likely include a nonbinding vote on pay and termination payment</p>
<p><b>Hedge Fund Registration:</b> Firms with &lt;\$150M AUM, SBICs and Venture Capital Exempt (&amp; foreign advisors &lt; 15 clients and no US place of business)</p> <p>SEC to establish disclosure and reporting requirements</p>	<p>The Senate version lowers the exemption to firms with &lt;\$100M AUM, and venture capital and private equity are both exempt</p> <p>Reporting to SEC on systemically important data such as investment positions, leverage, counter-party exposures, and types of assets</p>	<p>The final version is likely to follow the Senate exemptions for firms with &lt;\$100M AUM and venture capital</p> <p>The SEC will be authorized to require reporting on range of financial information, such as AUM, trading strategy, risk management practices, etc.</p>

House Passed	Senate Version	Likely Outcome
<p><b>Interchange Fees:</b> No explicit mention in the House version, although the new consumer regulator: 1) would be constrained by a "service provider" exemption from having jurisdiction over business-to-business transactions (which HFSC Chairman Frank, in committee deliberations, specifically referenced interchange as an example of); but 2) would nevertheless have future purview over regulations concerning the Electronic Funds Transfer Act</p>	<p>Section 1079 of Senate bill would require the Federal Reserve to issue regulations setting a "reasonable and proportional" fee that "an issuer or payment card network may charge with respect to an electronic debit transaction" for debit transactions based on the "actual cost incurred by the issuer or payment card network" within nine months of enactment</p> <p>The Board may consider the functional similarity between electronic debit transactions and checking transactions required by the Fed to clear at par</p> <p>The Board may distinguish between the actual incremental cost by the issuer or card network and "other costs" incurred by an issuer or card network that are not specific to a particular debit transaction –and these costs may not be included in the calculation of a reasonable fee.</p> <p>Prohibits a payment card from restricting merchants from offering a discount for the use of cash, check, debit card, credit card, or use of a specific card network</p> <p>Also requires card networks to allow merchants to establish a minimum or maximum amount dollar value for the acceptance of credit cards</p>	<p>The final bill will likely retain a modified version of the Durbin amendment (which passed the Senate May 13 without much advance consideration). Assuming publicly-stated resistance to the Durbin language from other House conferees, Chairman Frank is likely to force adoption of more comprehensive criteria that the Federal Reserve might use in determining a reasonable fee, possibly including such elements as fixed costs, a reasonable profit, and an allowance for the comparison of cost and effectiveness of other alternative payment methods</p> <p>Also meriting tossup odds or greater: A key change to distinguish between the Fed's treatment or consideration of network fees versus interchange fees (paid to card-issuing banks) within the Board's "reasonable-and-proportional" fee deliberations</p>

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