

Washington Notes:

Fall Legislative Update: Debt, Budget and Taxes - Oh My!

- There are very few completed items on the Congressional to-do list. Therefore, the Congress will attempt to complete a year's worth of work in less than three months.
- In the current politically-charged environment, this will prove to be a daunting task and consequently, we expect Congress to limit its focus to the work of the so called "Budget Super Committee", addressing the 2012 federal budget, attempting to deal with tax reform and debating ideas to create jobs and spur economic growth.
- We believe the work of the Super Committee could have ramifications for businesses across all sectors. Theoretically, everything will be on the table for the Super Committee's consideration and as such, there will be clearly defined winning and losing sectors coming out of this process.
- We expect the federal budget process to be highly partisan and likely to result in a continuation of funding at current levels.
- While significant attention will be paid to tax issues during the year, we do not expect a fundamental restructuring of the tax system will be adopted before 2012.
- While we expect the President to outline a significant amount of proposals to stimulate economic growth and job creation, many of them will not be enacted in the current political environment as Republicans do not want to allow him any type of major legislative victories.

▲ **Debt Ceiling** – The Budget Control Act provides the federal government with enough borrowing authority to stave off the next "default deadline" until early 2013.

▼ **Taxes** – While significant attention will be paid to tax issues during the year, we do not expect a fundamental restructuring of the tax system will be adopted before 2012.

▲ **Budget** – Once the Committee process runs its course, we expect the Congress to approve an Omnibus Appropriations bill or a long-term CR in late December or early next year that will run through September 2012.

▼ **Jobs Package** – We expect the President's jobs and economic package to incorporate a significant amount of proposals to stimulate economic growth and job creation. However, many of the proposals will not be enacted in the current political environment as Republicans do not want to allow him any type of major legislative victories.

▼ **Financial Reform** – Republicans continue an intense oversight process that has had some impact on the implementation of Dodd-Frank. Despite the numerous bills and hearings that have been initiated in the House, however, we do not expect the Congress to succeed in modifying or repealing the law.

▲ **Trade** – The Korea, Colombia and Panama FTA have a good chance to finally be adopted in the fall.

◀▶ **Energy** – The current political environment will make it extremely difficult to get any comprehensive energy package completed. While energy-related changes will be under consideration in the budget debate, we expect the focus to remain on pending regulations.

Overview

The federal government's fiscal house is in disarray, and by all reasonable projections, the budget will continue to grow much faster than the economy over the long run. While there is no shortage of ideas to bring spending under control and tame the overbearing tax code, policymakers have been slow to come together and reach an agreement on mechanisms to curb the problem. Many of these ideas, including

balanced budget requirements and fundamentally rewriting the tax code, have been around for a long time and are available for implementation, but to date, the Congress has taken little action.

The President and Congress have renewed their commitment to attempt to tackle these problems in the context of reducing the current federal budget deficit and increasing the debt ceiling, but there seems to be little reason to hope for major structural reforms in the short run. Further, their approaches to solving the deficit problems remain diametrically opposed.

The fall Congressional agenda will be dominated by the federal budget and fiscal policies. The Congress has to deal with the additional savings mandated by the Budget Control Act, adopt spending legislation for FY 2012 and potentially address tax reform. Any one of these issues would be enough to dominate a normal fall schedule, but taken together they will lead to one of the most significant and contentious sessions to-date. While it is unclear how all of these issues will be resolved, it is not possible that the Congress can simply ignore them and push off consideration for later.

The Budget Control Act mandates that the "Super Committee" report a product by November 23 and vote on it within a month. Failure to do so will lead to mandatory cuts in defense and entitlement spending. Such cuts are bad politically for each party ahead of elections in 2012. The threat of these cuts was obviously included in the budget agreement to act as a deterrent to gridlock, but in light of the current partisan standoff among lawmakers, this deterrent may not be enough to force a consensus.

The federal fiscal year ends on September 30 and neither chamber has made much progress on completing the necessary spending bills that will fund the government in 2012. Normally, this would pose a major problem and a continuing resolution would be put in place to fund the government at existing levels. The debate over the 2011 budget, however, changed this dynamic as mandatory spending reductions were a part of the equation for the first time. The debate about further reductions that dominated the debt ceiling negotiations will also complicate the ability of Congress to quickly resolve the FY 2012 budget.

Tax policy is one of the most significant sticking points in the budget battle between Republicans and Democrats. Despite the claims from both sides that they believe they can work together on broad reform, there are fundamental differences in the approaches espoused by each Party. Democrats and Republicans believe they can achieve an agreement on tax reform, but each Party has vastly different concepts of what constitutes "fundamental" reform. Republicans prefer to focus on major reductions in federal spending in the short run and to pursue corporate and individual tax changes as a longer-term solution to fiscal stability. Democrats believe that a 50-50 mix between spending and revenue generation is the key to budget discipline.

Debt Ceiling Politics

House and Senate leaders have named their respective representatives to the Joint Committee established by the Budget Control Act. In our view, the Committee has been populated to give the respective leaders the ability to totally control the process. These are all loyalists and represent the various factional elements of each party. Accordingly, they can be counted on to not cut any side deals, provide political protection for the leaders and provide enough expertise to legitimize the Committee. The ultimate decision will not be made by the members on the Committee, but by the respective Congressional leaders. As such, the process will likely resemble the back and forth debate recently endured over the past few months and will be highly political.

The Committee's primary mission is to find at least an additional \$1.2 trillion in savings over the period 2012 through 2021. There is any number of challenges facing the Committee that could undermine its effectiveness. First and foremost is the calendar. The panel is due to receive recommendations from legislative committees, several of which are chaired by super committee members, by Oct. 14. Within 40 days subsequent — by Nov. 23 — the committee, which is to be co-chaired by Jeb Hensarling (R-TX)

and Senator Patty Murray (D-WA), must report its product to the full Congress. Further, within a month thereafter, under expedited procedures, the House and Senate must vote on the plan.

A second major factor is the prospect of automatic spending cuts. If the Committee does not act during the prescribed timeframe or falls short of the \$1.2 trillion in spending reductions, automatic spending cuts – known as “sequestration” – will be triggered. Therefore, if the Committee does nothing, \$1.2 trillion in cuts will be required and if they are only able to cut \$200 billion, for example, the remaining \$1 trillion will come from automatic spending cuts.

These spending cuts will come from the defense and entitlement portions of the budget. Reductions in either of these categories carry political risks for each political party, especially in a major election year. While there is a real prospect that the process could end in sequestration, it puts a lot of pressure on each side to conform or face angry base voters in a pivotal election.

A final major factor is the inclusion of revenue generating provisions in any plan approved by the Joint Committee. While the debt deal allows for the consideration of revenue generating provisions to reach the deficit reduction targets, the issue has proven to be a political time bomb. Democrats believe revenues must be a major component of any deal as spending cuts alone would lead to reductions in key social programs important to their base voters. Republicans, with a few exceptions, have been steadfast in opposition to the inclusion of any revenue provisions. Given this opposition and the need to get any deal through the House, we do not believe many revenue generating provisions will be included in a final deal. Instead, the focus will be on spending reductions.

While there is no limit on how little or how much deficit reduction the committee can produce, the goal of \$1.2 trillion to \$1.5 trillion more than the \$900 billion-plus that already has been cut is a steep target that proved elusive for the President and top congressional leaders. The Committee’s work will be very important because of the broad scope of issues it will be considering to achieve savings and reduce the federal deficit.

Theoretically, everything will be on the table and there will be clearly defined winning and losing sectors coming out of this process. There is no shortage of forces that will seek to influence the process and carve out programs of interest to them. Some would prefer to see automatic, across-the-board cuts take place if their own interests are on the committee’s chopping block. The President’s plan to make what is being billed as a major speech in early September laying out new proposals for job creation and deficit reduction is viewed by many as another example of lobbying efforts to influence the Joint Committee’s deliberations. In short, there will be significant lobbying going on between now and Christmas.

Entitlement Spending - If the Super Committee members fail to agree on a plan or fall short of any compromise, a series of automatic spending cuts to entitlements would kick in by 2013. Included in these automatic cuts is an across-the-board, 2 percent cut to all Medicare providers (Medicaid would remain intact). Either way, the Committee Members will find it nearly impossible to get by without dipping into the big health care entitlement programs — Medicare and Medicaid. There’s a pretty long menu of ideas to choose from, thanks to the work that’s already been done by the bipartisan negotiations led by Vice President Joe Biden. Further, the Committee will also be able to draw from the suggestions of other bipartisan groups, like President Obama’s fiscal commission and the Senate Gang of Six. The following is a listing of ideas that could be considered by the Committee. It is important to note that while all off these ideas are politically charged, they represent a sampling of the provisions the Committee members will be able to realistically consider given the very constrained timeframe.

- Crack down on Medicare fraud and abuse
- Raise the Medicare eligibility age
- Restructure Medicare benefits
- New rules for Medigap plans

- Fix the Medicare physician payment formula
- Raise Medicare Part B premiums
- Cut hospital payments for bad debts
- Nursing homes/home health cuts
- Premium support pilot program
- Create Medicaid block grants
- Medicaid “blended” matching rate
- Drug rebates for Medicare-Medicaid “dual eligibles”
- Repeal the CLASS Act

Defense – The debt ceiling deal adopted by Congress dictates a \$350 billion, 10-year reduction in defense spending. The initial caps on discretionary spending included in the debt ceiling deal will likely result in the FY 2012 base defense budget falling to \$525 billion. In comparison, the current level of funding for FY 2011 is \$530 billion and the president’s request for FY 2012 is \$553 billion. If the Joint Committee does not enact a bill, the mandatory trigger provision would automatically cut the FY 2013 base defense budget to approximately \$472 billion. This compares to the CBO baseline of \$549 billion and the president’s FYDP projection of \$571 billion for FY 2013. The trigger would return the base defense budget to its FY 2007 level of funding in FY 2013, adjusting for inflation, and would hold it near that level for the following eight years. The potential for \$500 billion more in defense cuts could force the Pentagon to cancel or scale back multibillion-dollar weapons programs. Given the abruptness of the cuts imposed under the trigger and the real possibility that Congress may not be able to reach a deficit reduction compromise in time to avoid the trigger, there is significant concern for the non-operational side of the defense sector.

Education - The Pell Grant Program, at least for the near future, appears to be safe from the potential demise it once faced during the on-going budget and debt ceiling negotiations. However, while Pell Grants may be off the bargaining table, other areas of the debt deal will have an impact on the higher education sector. In early negotiations over the Budget Control Act of 2011 (BCA), lawmakers agreed to eliminate discounts given to student loan borrowers who pay their loans on time, as well as to remove the interest rate subsidy for all federal government originated or guaranteed professional and graduate-level student loans. These incentives will disappear for Federal loans made after July 1, 2012. Notably, Congress agreed to language in the BCA that explicitly exempts the implementation of BCA Title V mandated rules from “negotiated rulemaking”. The Department of Education will not be required to “negotiate with affected parties” before putting proposed rules out for public comment.

Other college aid programs, including Federal tax breaks that help offset higher education costs, may also be scaled back. While we do not believe that cuts in college aid will be the Committee’s preferred method of arriving at their \$1.2 trillion reduction, at this stage in the game, the option cannot be ruled out.

Transportation – Transportation is one of the few issues that enjoy bi-partisan approval. The current spending trend, however, is untenable beyond the next two years. The House has released a proposal to consolidate programs as well as eliminate items that are redundant or not essential. It also seeks to leverage private dollars through Public-Private Partnerships. The Senate has yet to release a plan and the Administration is advocating nearly doubling spending. This seems to be a proven recipe for gridlock.

Infrastructure – Similar to transportation, there is bi-partisan agreement on the job creating effect of infrastructure spending. The Administration continues to discuss a national infrastructure bank to leverage government guarantees in exchange for private sector dollars. The initial seed capital ranges from \$10 to \$50 billion. It is hard to see with the stimulus being pilloried as an example of wasteful and ineffective government spending that agreement could be reached on creating a national infrastructure bank.

Jobs and Economic Growth

All eyes in D.C. are being trained on the White House in anticipation of the President's speech on job creation and economic recovery on September 8th. The Administration is still tinkering with existing ideas and vetting some new proposals from Congressional Democrats and interest groups. We do not expect a final proposal to be completed until right before the speech. The Administration has noted that the President's proposal will be dynamic and as such he will remain open to new ideas beyond what is outlined next week.

In our view the emphasis of the President's speech will be on proposals that the Congress will have to agree to adopt. He is doing this because these are the measures that can be the most far reaching and impactful. Anything that the Administration can do on its own will be limited in scope and long term impact. The President is also emphasizing provisions that Congress must approve to make a political point. He wants to demonstrate that he has proposals on the table and if they are not done, it is the fault of Congress and not his Administration. We do not believe that Congress will take the bait and therefore many of the proposals will not be adopted this year. There are some, however, that enjoy bipartisan support and could be adopted in the context of the budget "Super Committee" effort or at the end of the year as a part of a tax extenders package.

Here are a few things that are expected to be in the President's jobs package. This is not a comprehensive list and as previously noted the prospects for enactment are not good.

- Extension of the payroll tax cut deduction
- Extension of unemployment benefits
- Long-term extension of Highway bill
- Adoption of patent reform bill
- Adoption of existing trade agreements
- The creation of a National Infrastructure Bank
- An outline for long term mortgage reform

Budget/Continuing Resolution

The funding for fiscal year 2011 expires at the end of September and the Congress is not close to approving all of the funding bills necessary to keep the government operational in the 2012 fiscal year. This delaying in approving funding measures is the continuation of a trend that has led to one government shutdown (1995) and a near shutdown (2011). While the House has approved a budget for 2012 and has begun to process many of the necessary individual appropriation bills, the Senate never approved a budget and is far behind the House appropriations process. To-date, the Senate has only approved one of 13 appropriation bills.

Given the shortage of time and the massive delay in the Senate appropriations process, it is clear that the Congress will have to pass a continuing resolution (CR) to keep the government operation when the new fiscal year begins on October 1st. We expect the short-term continuing resolution is likely to extend through late December to give the Super Committee time to complete its work. Once the Committee process runs its course, we expect the Congress to approve an Omnibus Appropriations bill or a long-term CR in late December or early next year that will run through September 2012.

The FY 2012 funding measure will represent the first test of Congress' ability to follow through on the debt ceiling deal. The deal requires \$917 billions in spending reductions over the next decade beginning with FY 2012. These savings can be achieved through caps on discretionary spending and are enforceable through across-the-board spending reductions. While all \$917 billion will not be realized in FY2012, Congress will want to demonstrate its commitment to tackling the current deficit by making substantial cuts in spending immediately. It is currently unclear what specific programs will be impacted

the 2012 budget bill, but in our view there is significant broad-based risk for a variety of sectors given the mandates of the debt ceiling deal.

Tax Reform

While significant attention will be paid to tax issues during the year, we do not expect a fundamental restructuring of the tax system to be adopted before 2012. This is due in large part to the fact that Congressional elections in a Presidential year will scare many Members away from the controversial issues inherent in such an exercise. For example, the majority of Democratic Members of Congress are not likely to want to vote to reduce corporate tax rates when they believe their constituents would be dissatisfied with such a vote. While the political rhetoric on overhauling the tax code will continue, any significant changes will require serious modifications that will take more time and political will than currently exists. Given this broad policy divide between the Parties, we do not believe fundamental tax reform is likely to occur until after the 2012 elections.

In recent months, a number of tax issues have taken a central role in the larger debate of tax reform. Below, several of these measures are discussed in more detail:

- **Territorial Tax System** - The President's debt commission recommended that the U.S. adopt a territorial tax system to replace the current worldwide structure. Under a territorial system, the offshore profits of a U.S. corporation would be exempt from U.S. taxes. The debt commission reasoned that such a system would eliminate the double taxation inherent in a worldwide system and increase the competitiveness of U.S. companies operating in foreign countries. The Commission also noted that a territorial tax system is simpler to administer and could significantly reduce the bureaucracy associated with a worldwide approach. Republicans support the concept of a territorial tax system because of the ease of administration and the potential to eliminate double taxation.

Democrats, on the other hand, are concerned about the prospects of providing U.S. corporations with a greater incentive to engage in profit-shifting, meaning practices used to disguise U.S. profits as foreign profits. A common example is the manipulation of transfer pricing to shift corporate profits into countries that do not tax, or that lightly tax, certain types of profits. Democrats are also concerned that a territorial tax system will provide corporations with a greater incentive to shift actual operations — and jobs — to other countries. Despite the potential benefits of a territorial tax system, we believe the politics behind the concerns of Democrats are likely to ultimately push the debate away from seriously considering such a system.

- **Corporate Tax Rate Reduction** - While both Parties would like to reduce the current corporate tax rate, they differ on the best approach to achieve such a reduction. Democrats believe any reduction must be accompanied by reductions in credits and other deductions available to corporations. These offsets will serve to make the corporate rate reduction revenue neutral and reduce the deficit impact of the change. Republicans, however, would prefer to reduce the rates without corresponding reductions to credits and business deductions. They largely believe the economic growth spurred by a reduction of the corporate rate will offset its cost. This issue has been the source of significant debate in Congress, but we do not expect a resolution on this issue this year.
- **Payroll Tax Credit** - The Administration and bi-partisan majority in Congress support an extension of the current two percent payroll/self-employment tax holiday. The measure was enacted last year as a part of the package extending the Bush tax cuts and is scheduled to expire at the end of this year. The provision is seen as a good economic stimulus and given the bipartisan support; this measure is likely to be extended. It would, however, have to be part of a larger package and cannot stand alone given the revenue impact it would have on the current deficit. There are currently discussions about extending the tax holiday to

employers as well. In our view, such an action is completely dependent on the cost associated with the provision. The more it costs, the less likely it is to be done.

- **Bonus Depreciation** - An extension of the current law provision allowing businesses an extension and temporary increase in bonus depreciation for investments in new business equipment enjoys bipartisan support and is likely to be extended. The measure provides an increased ability to recover the cost of capital expenditures over time according to a depreciation schedule. For investments placed in service after September 8, 2010 and through December 31, 2011, the law provides for 100 percent bonus depreciation. For investments placed in service after December 31, 2011 and through December 31, 2012, the law provides for 50 percent bonus depreciation. The law also allows taxpayers to elect to accelerate some AMT credits in lieu of bonus depreciation for taxable years 2011 and 2012.
- **Repatriation** - There has been some renewed interest in Washington and in the investor community on the prospects of a new repatriation tax “holiday.” This essentially allows companies to return deferred overseas earnings at a reduced tax rate. Despite the fact that many in the business community would be supportive of such a proposal, we believe there are several indicators this will not likely be enacted this year or next.

First, the Administration remains opposed to any repatriation proposal outside the context of fundamental tax reform. It believes the business community must give up some benefits in exchange for this provision. The Administration seems to be warming to the idea of setting aside a portion of the repatriated funds for infrastructure spending. They have not, however, yet made any firm commitments. Second, supporters of the provision must overcome the political perils of supporting a measure that is projected to lose \$80 billion in revenue during a period of supposed fiscal restraint. While they argue the economic impact of the money brought back onshore will cover most of this projected loss, they have not been able to fully account for the full amount. Any Member voting for such a provision would have to defend against such a perceived “give away” to business and while practical, it is not easy in an election year. Third, despite the interest in the provision, there has been little political momentum in the Congress towards passage. Although several repatriation bills have been introduced in the House, we do not believe they will be successful.

We do not expect repatriation to be actively considered by the Joint Committee. However, it will remain in play for an end of year omnibus appropriations bill or continuing resolution. We do not currently believe the provision will be successful this year.

- **Carried Interest** - Changes to the treatment of carried interest are only likely to occur in the context of broader tax reform, and would be one of several options discussed. Carried interest changes are very unlikely as a stand-alone measure for the next two years because the Republican-controlled House would not adopt the provision on its own.
- **GRATs** - Grantor-retained annuity trust reform, like carried interest, has been a popular candidate as a revenue raiser. Current law provides that a GRAT's remainder interest is determined by the present value of the retained annuity during the grant term, based on the fair market value of the trust property. The Administration has proposed to require a minimum ten-year term, with remainder interest greater than zero, with no decrease in value over the term permitted. If a budget deal is reached that requires revenue offsets, GRATs are potentially on the table, but the chances are slim there will be many smaller tax bills until tax reform is undertaken.

- **Tax Extenders** - Congress regularly passes one-year extensions for expiring provisions, such as the research and development tax credit, excise tax measures, and Subpart F active financing exemption. Although many of the prior year extenders were adopted last year as a legislative compromise, they will expire at the end of 2011 absent Congressional action. Last year, a number of tax and non-tax policy provisions were added to the extenders bill, but ultimately were not enacted in the year-end deal. This year, a straight-forward extenders measure may be adopted before the end of the calendar year.
- **Energy Taxes** - In light of increased energy prices, the Administration and some in Congress have called for repeal of tax provisions that favor oil and gas companies. Several measures that have been cited include repeal of Section 199, which provides incentives for domestic production of oil and natural gas, repeal of intangible drilling cost expensing, and changes to the dual capacity tax rules. Proposals to reduce or restrict tax deductions for oil and gas companies are estimated to raise about \$1.2 billion in 2012. The Senate is likely to vote on a bill that would close these tax “loopholes”, but the legislation is not expected to pass. Energy companies would also be impacted by changes in corporate taxation. In addition, any changes to the current treatment of MLPs would dramatically adversely affect energy transmission firms, such as pipeline operators.
- **Bank Fee** – The Administration remains committed to its bank tax proposal and it is likely to be brought up in the debate this fall on deficit reduction. The measure never gained consensus last year in a Democratic Congress. Besides the lack of consensus on what approach to take on a bank tax, the rationale behind the need for the provision (TARP repayment) is working against the provision. Republicans have always preferred to comply with the requirements of the TARP legislation and wait until 2013 to see what outstanding balances were pending. The Administration’s touting of the shrinking TARP deficit has produced good headlines, but has also served to reinforce the Republican position. We do not expect this provision will be viable this year with Republicans in control of the House.

Other Legislative Issues Outstanding for the Year

Energy Policy

The political environment this year will make it extremely difficult to get a comprehensive energy package completed. While we do expect discussions in both chambers of Congress on energy policy changes, the real focus will be on pending environmental regulations.

Despite last year’s failure to enact a carbon capture regime, the Administration has repeatedly stated that they would be willing to regulate what they could not legislate. The Senate narrowly defeated a measure aimed at rescinding the pending rules, which is offered as proof that the Administration has a tin ear on the topic and rallies the opposition.

- **Gas Production/Hydraulic Fracturing** – Despite an increased call by some Congressional Democrats for the EPA prohibit hydraulic fracturing, we do not expect such an extraordinary step to be undertaken this year. The EPA has been moving forward with an effort to have fracking fluids disclosed and have been working with local jurisdictions to document potential environmental issues. The SEC recently added a new wrinkle to the debate by requiring disclosure of fluids and potential risks of materials to investors. Proponents of regulation are concerned about the environmental degradation associated with the technique and were able to have funding included for a study of hydraulic fracturing's impact on drinking water sources in the 2010 EPA funding bill. Opponents of a shift in the regulation of this technique, which includes some major environmental groups, point to the importance of the practice to extract the significant amount of natural gas recently discovery in shale fields. They point out the environmental benefits of lower carbon

emissions from natural gas versus petroleum and highlight the number of jobs that could be created from the development of these major fields. Pending the results of the EPA study which is not expected until 2012, we believe this issue will continue on a back burner.

- **Off Shore Permits** – This continues to be a contentious topic between Democrats and Republicans. Given the new safety guidelines and the federal resources required to meet the mandate, we expect the Gulf drilling permits to continue to face an uphill approval process. The offshore drilling issue will continue to simmer as House Republicans and Gulf state Democrats beat the drum to speed up the application review process. The Administration has shown minimal signs of relenting. This was evident in the establishment of the new Bureau of Ocean Energy Management, Regulation and Enforcement and discussions to potentially allow previously approved permits to move forward without new environment reviews. In fact, an effort was made last year to include language in an appropriations bill that would increase the offshore permit review mandate from 30 to 90 days. While this did not ultimately succeed, it does show the continual effort to include larger gaps in the application process. We expect similar efforts to be brought forth on other legislative vehicles.
- **Keystone XL Pipeline** – This project would open the vast Canadian oil sands to idle American refinery capacity by building on a current system to deliver oil sands from Alberta to Texas. Despite the expected job creation and sourcing more energy closer to home, this \$13 billion project has been held up for review at the State Department. Initially, it was anticipated as a slam dunk approval; however, several complications have arisen including a minor leak in the existing system that has only solidified resistance to the project from the EPA and other environmental non-profits. The drawn out process of environment reviews is beginning to change the financial model and speculation is that if the approval is not done soon, it would be economic to build a pipeline to Vancouver for Asian markets. The House did pass legislation to impose a timeline by which the State Department must deliberate and either grant or deny the permit, but this is not expected to pass the Senate. In the short-term, this will be cited as evidence by both sides of how the Republicans do not care about the environment and how Democrats are not serious about jobs or securing reliable energy sources.

Reauthorization of Surface Transportation

Despite a significant amount of political rhetoric about the job creating benefits of a transportation bill, the Congress and Administration are not close to finalizing a long-term deal. The current surface transportation funding mechanism expires September 30, and if not reauthorized, the federal government cannot collect gasoline and other excise taxes that make up the Highway Trust Fund. There have been a series of short-term extensions of the program, but the structural funding shortfall requires that it be addressed. We believe a simple extension at current funding levels is the most likely outcome this year.

Financial Regulatory Review

House Republicans continue to raise serious concerns about the volume and impact of the Dodd-Frank implementation rules. They remain committed to scrutinizing the regulatory process through oversight hearings and legislation to modify the law. The oversight process has had some impact on the regulators and rules they put forth to implement Dodd-Frank. Nonetheless, while political pressure may aid in making some rules more palatable, we do not expect Congress to succeed in fully repealing the law.

Perhaps the greatest impact House Republicans have had on the implementation process is the withholding of funds from the agencies charged with crafting the rules. They have already met with some success in this effort by refusing to significantly increase funding for the SEC and CFTC for FY 2011. The lack of funding impacts the ability of the agencies to hire the staff necessary to deal with the volume

of work called for by the new law. This further slows down the implementation process and puts pressure on regulators to be responsive to the Congress. While an increase in funding is likely for this year, it will not be near the amount the Administration would like and in our view, will negatively impact the implementation schedule. We expect the implementation schedule will continue to slip and that many of the most significant Dodd-Frank rules will not be finalized this year.

Trade

The Korea, Colombia and Panama FTAs have a good chance to finally be adopted in the fall. Despite bipartisan support for these pending FTAs, the primary hold up is the Administration's insistence that a renewal of the Trade Adjustment Assistance program (TAA) be completed along with the adoption of the FTAs. Republican lawmakers, disenchanted with the US\$1-billion-a-year program, demand a separate approach. The President has noted that he only plans to submit the FTAs to Congress when he is confident that both the FTAs and the renewal of TAA are guaranteed. There has been significant discussion surrounding a resolution to the TAA issue and we believe a separate vote reauthorizing the measure will clear the way for consideration of the pending FTAs.

Nominations

An increased Republican caucus in the Senate has made the nomination process for Administration officials more difficult. This has created a major headache for the President given the significant amount of turnover in the various Cabinet agencies during the past year. There are currently nominees pending for the SEC, Treasury, CFTC, Federal Reserve, FDIC and the OCC. It is not currently clear that all of these nominations will be approved this year, for a variety of reasons surrounding the implementation of Dodd-Frank. A postponement of these nominations will have an impact on the agencies ability to implement the provisions of Dodd-Frank, but will not stop it entirely.

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