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Brief Overview of the Dodd-Frank Act Updating Financial Regulation

On July 21st of this year, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). As most commentators have noted, the Act constitutes the most significant change to the regulation of financial institutions since the 1930s. This Act mandates significant studies and the promulgation of regulations, by some measures up to 240, necessary to implement the legislation. Significant discretion has been shown to the banking regulators and the Securities and Exchange Commission, among others, to fully implement the legislation, and it will be years before we fully understand its impact.

By Tom Blank

Due to the length (over 2,300 pages) and complexity of the Act, this article will merely highlight a number of the more important provisions and will be divided into sections referencing changes impacting banks and bank holding companies, securities reform, and corporate governance and compensation reforms impacting public companies.

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1. Banks and Other Financial Institutions

The Act generally maintains the existing structure for banking regulation, unlike some of the original proposals that discussed extracting retribution from the Federal Reserve and other regulators for having "failed" to properly monitor and address the problems that existed in financial institution oversight. The Federal Reserve will continue to regulate bank holding and financial holding companies, as well as state "member banks," the FDIC will continue to insure the deposits of financial institutions and regulate and oversee "non-member" state chartered banks and the OCC will continue to be responsible for the examination and oversight of national banks. State banking regulators still will have the authority to charter financial institutions as well. The one casualty among the banking regulators is the Office of Thrift Supervision ("OTS"), the regulators of "thrifts." It will be eliminated with its principal duties transferred to the OCC for federally chartered thrifts, the FDIC for state chartered thrifts and the Federal Reserve for holding companies of these institutions. While existing thrifts will be grandfathered and allowed to continue to exist, commentators speculate that due to the increased penalties for violation of the qualified thrift lender test and other tighter restrictions, many of these institutions will convert to national banks. In addition, many commentators have suggested that the other regulators will penalize former OTS-chartered institutions due to the perceived "lax" regulation previously imposed upon them by the OTS.

The Act also creates the Financial Stability Oversight Council which was established to protect the United States financial system from systemic risks. The Council will consist of 15 members representing banking, securities and insurance regulators with the Secretary of the Treasury serving as Chairperson. The principal goal of the Council is to provide oversight for the entire financial system of the United States. In addition to the Council, the Act grants to the FDIC authority to liquidate failing bank holding companies and related affiliates of banks with significant procedural limitations.These two provisions were included in the Act in an effort to avoid the type of situation created by American International Group ("AIG"), which had many different component parts and many different regulators, with no one seemingly in charge of the entire organization.

One of the more meaningful actions taken in the Act is the creation of the Bureau of Consumer Financial Protection, an autonomous agency within the Federal Reserve. This Bureau has been established to consolidate examinations for consumer compliance for banks with $10 billion or more in total assets and certain other entities including mortgage brokers. The rules created by this Bureau will apply generally to all banks, regardless of size, with enforcement for smaller banks left to bank regulators. While payday lenders, check cashers and certain other non-bank financial firms will be regulated by the Bureau, auto dealers and pawn brokers escaped such oversight. Commentators have noted that the impact of the Bureau could be one of the more significant aspects of the Act. The creation of the Bureau was one of the more contentious issues contained in the legislation. For a while, it appeared that the Bureau would be created as a truly independent entity, but in the end, the Bureau was housed under the Federal Reserve. Because of the fact that significant consumer protection legislation already exists and is enforced by various bank regulatory entities, there was some question whether the new entity, with its proposed initial $850 million budget, was necessary. There is some concern that the creation of the Bureau will burden consumer lenders and further contract the lending in this sector resulting in some parties leaving this service entirely.

The Federal Office of Insurance ("FOI") was created as a new entity housed within the Treasury Department to review insurance matters other than health, long-term care and crop insurance. Initially, this Office of Insurance is intended to engage in information gathering and monitoring the insurance industry in the country as a whole. The Office is required to deliver a report to Congress within 18 months. Many had pushed for the creation of a federal oversight of insurance, which is currently regulated at the state level. It is unclear whether the creation of the FOI is a precursor to the federal regulation of insurance intending to preempt state authority.

The Act also reforms mortgage underwriting and provides certain anti-predatory lending restrictions. The intent of this portion of the Act is to require lenders to ensure that a borrower is able to repay a home loan by verifying the borrower's income, credit history and job status (what a novel concept) and ban payments to brokers for steering customers to more highly priced products.

Interestingly, the Act, notwithstanding its breadth, did not deal with the resolution of Fannie Mae or Freddie Mac. Many have deemed this to be the greatest failing of the Act noting that the projected exposure for these entities now owned by the government ranges as high as $500 billion. Apparently, attempting to reign in these entities was not something that was politically possible in the effort to have the legislation passed this year.

Finally, the Act permanently increased to $250,000 per account the deposit insurance provided through the deposit insurance fund. Interestingly, the increase was made retroactive to January 1, 2008, which will mean that depositors who lost money in institutions resolved prior to the implementation of this increase by the FDIC in October 2008 (such as IndyMac) will be protected.

2. Securities Reform

One of the provisions in the Act that probably has received greatest press is the so-called "Volker Rule" named after Paul Volker, former Chairman of the Federal Reserve. The intent of this Rule is to limit the ability of banks and financial institutions to participate in proprietary trading. While this is likely to impact only the most significant financial institutions in the country, it will have a meaningful impact upon those entities. Banks will be allowed to invest only up to 3% of their "Tier 1" capital in hedge funds, and may not own more than 3% of any one fund. To some extent, this provision attempts to turn back the Gramm-Leach Bliley legislation which effectively abolished the Glass-Steagall Act in 1999. This activity has provided significant revenue to the largest financial institutions in the country and there is some belief that this limitation will cause those institutions to segregate proprietary trading into different entities. Derivatives regulation is another aspect of the Act that will impact larger financial institutions. First, the Act forces to an over-the-counter clearing market a significant portion of the derivatives industry in an effort to

be more transparent and stable. It also requires a separation of certain derivative or swap activities from the bank itself into a non-depository affiliate.

Securitizations also have been dramatically impacted by the Act. Recognizing that securitization of various assets, some of which proved to have little or no value, was a significant contributing factor to the economic meltdown, the Act would require banks to maintain at least 5% of the credit risk for any securitizations. This provision known as "skin in the game" is intended to make certain that institutions are not able to make a quick buck by securitizing worthless assets and moving on. Finally, the Act imposes strict new standards limiting the conflict of interest of credit rating agencies. Previously, Standard & Poor's, Moody's and Fitch were paid by the varying investment bankers seeking ratings for instruments that they were in the process of selling. This conflict of interest is deemed also to have contributed to the financial meltdown due to the seemingly generous ratings provided to now seemingly worthless assets.

The Act also modifies the definition of an accredited investor for purposes of private placement offerings. Previously, the definition included the individual's principal residence in determining if he or she met the minimum $1 million net worth threshold to constitute an accredited investor. The Act now specifically excludes the person's primary residence in that measure. Additionally, the Act mandates that the SEC review the definition of accredited investor within four years from the adoption of the Act and every four years thereafter. There is significant concern that the SEC will move to drastically increase the minimum net worth and income tests provided in Regulation D, which have not been significantly modified since its original adoption in 1982.

Finally, in the securities areas, and of interest to brokers, dealers, registered investment advisors and trust companies, the SEC is obligated to undertake a study reviewing the standard of care for persons providing "personalized investment advice" to "retail customers." The SEC's task is to determine whether the "fiduciary standard" typically applied to fiduciaries and RIAs should be imposed upon brokers and dealers as opposed to the "suitability standard" which currently is imposed. Not surprisingly, this proposal has garnered significant comment to the SEC.

3. Corporate Governance and Compensation Reforms

In addition to specific actions affecting financial institutions as noted above, the Act implements a number of corporate governance and compensation reforms for all public companies. First, all public companies will now be required to have advisory (non-binding) votes taken at their annual meeting concerning pay packages. In 2010, there were approximately 80 companies who sought shareholder advisory votes regarding compensation plans, and an additional 650 companies whose "say on pay" votes were mandated due to the fact that they had participated in the Troubled Asset Relief ("TARP") Program. The Act will mandate that companies both take the vote and address in its proxy statement what action they will take if a majority of the shareholders vote against a pay package.

The standards for independence on compensation committee members has been heightened and is similar to that provided for audit committees. The committee itself, as opposed to management of the company, is required to retain any outside compensation advisors. The Act provides that any Exchange (NYSE, NASDAQ, etc.) will be required to delist a company that fails to conform to these practices within one year.

Clawbacks have been expanded. Originally a result of the Sarbanes-Oxley Act ("SOX") and reinforced under TARP, Clawbacks will now be required of all executive officers, as opposed to only the CEO and CFO as required under SOX. The Act requires that an executive repay his or her employer or former employer, on a three-year lookback standard, for any "material noncompliance" with financial statement preparation as opposed to the higher "misconduct" standard imposed under SOX. In the area of compensation disclosure, the Act mandates disclosure of median pay of all employees compared to that of the CEO and requires that the proxy statement or annual report contain a chart comparing executive compensation to stock performance over a five-year period. Some commentators have noted that this could result in a short-term, as opposed to longer-term, outlook for a company's compensation practices, which may not be desirable. Finally, the SEC recently adopted regulations that would allow persons with a greater than 3% ownership of a public company that have maintained that ownership position for three years or more to place nominees in the company's proxy statement. This proxy access rule was to have become effective for larger companies in 2011 and for all smaller reporting companies beginning within three years. However, due to a lawsuit filed by the Business Roundtable and the Chamber of Commerce, the SEC on October 4, 2010 stayed the implementation of this new rule. It is unclear when this matter will be finally determined, but commentators feel that the rule will not be in place for the 2011 proxy season.

As noted in the introduction to this article, many of the provisions of the Dodd-Frank Act will be subject to interpretation, regulation and rule making for many years. However, as you can see from this brief review, the Act will have a significant impact upon the financial system in the United States. As is true with any legislation enacted in response to a perceived systemic failure (such as SOX), the Act may be deemed to have gone too far in some instances, while avoiding dealing with the Fannie Mae and Freddie Mac looming issue. Please note that there are a number of additional provisions of the Act not addressed in this article due to their complexity and limited applicability. Stay tuned for what the regulations and rule makings do for the implementation of the Dodd-Frank Act.

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