

# ***A Closer Look***

## **The Dodd-Frank Wall Street Reform and Consumer Protection Act**



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Special edition

## ***Dodd-Frank at the Six-Month Milestone***

### **A Work in Process**

March 2011

#### ***Overview***

When the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank, or “the Act”) was enacted in July 2010, many said that it was the most significant remake of the US financial services sector since the Great Depression. That turned out to be an understatement. The six months following passage have demonstrated that Dodd-Frank’s reach impacts not only every segment of the financial services industry but also the rest of corporate America in ways that may not have been fully anticipated. To paraphrase Winston Churchill, never has so much been demanded by so few of so many in so short a period of time.

This special edition *A Closer Look* summarizes the key progress on Dodd-Frank as of the six-month milestone (and, in some cases, slightly beyond).

## Getting organized

During this first milestone period, both the public and private sectors have focused on getting organized. For the government, that has involved attending to such structural matters as establishing the Financial Stability Oversight Council (FSOC), developing the infrastructure for the Consumer Financial Protection Bureau (CFPB), planning the transition of thrift and thrift holding company<sup>1</sup> supervision from the Office of Thrift Supervision (OTS) to other agencies, and creating a number of new offices within existing or new departments, bureaus, or agencies. Some of these efforts have proceeded apace: The FSOC, for example, has already had three meetings and issued several reports. However, lack of funding for some agencies has caused delays in the establishment of some new offices mandated by Dodd-Frank.

In the extensive rulemaking that occurred during the first milestone period, it was apparent that coordination and consultation has never been more important, especially since many rules require multi-agency agreement or involvement. While the rulemaking process has followed the framework of the Administrative Procedure Act with advance notices of proposed rules, notices of proposed rules, and publication of interim or final rules, the sheer volume of effort required has resulted in greater agency willingness to be “transparent” by meeting with interested parties before issuing proposals and by conducting roundtables or other outreach efforts to encourage early communication. That transparency has been needed to offset to some degree the shorter comment periods involved on proposals—mostly in the 30- to 60-day range (rather than the more typical 90-day period used in major rulemakings). By any measure, the rulemaking process has been compressed to deal with the volume of proposals and to meet statutory deadlines.

For private-sector firms, developing a process for evaluating, prioritizing, and influencing the possible impacts of Dodd-Frank has been job number one. The impact analyses conducted by firms during the first six months of Dodd-Frank have been less about developing detailed implementation plans and more about identifying the possible impacts and informing the firms’ efforts to influence the final outcome of the regulatory process. Regulators have emphasized that boards of directors should ensure that senior management be well-engaged in overseeing their firms’ Dodd-Frank implementation.

Some of the largest firms have organized formal, centralized project management office (PMO) efforts to ensure a consistent approach to conducting the impact analyses, to prioritize issues and resources, and to ensure that there is a single corporate point of view being presented to regulators on key issues. Others have mixed smaller, centralized PMO structures with ad hoc groups formed within business units around specific issues impacting those businesses. Firms that perceive a more targeted impact of Dodd-Frank on certain business areas, rather than a broad-based impact across the organization, have been more content to go with an ad hoc method.

In our view, the more formal, centralized approach is preferred since it encourages the kind of unified and efficient strategy that is critical in a time when compliance deadlines are likely to be short, and when opportunities to meet with the regulators, submit individual

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<sup>1</sup> Technically, thrift holding companies are regulated as savings and loan holding companies. We use instead the term *thrift holding companies* to reflect the fact that “thrift” is a more encompassing description and that “savings and loan” has become somewhat anachronistic.

comments, or work with trade associations or others on industry comments is complicated by the number of rulemakings running in parallel, and the rapid-fire deadlines.

### ***The importance of process***

In a recent speech, Securities and Exchange Commission (SEC) Commissioner Elisse B. Walter made a number of points about the importance of “process” in such an exercise:

“[P]rocess helps companies deal with difficult problems and comply with complex regulations. For example, process enables companies to compile and assess the sometimes vast amounts of information necessary to produce accurate, reliable, and timely financial statements.

“Process is also essential to ensuring that companies know exactly where they are and where they are going. A complete and thoughtful process should encourage thinking about collective decision points from legal and strategic vantage points.”<sup>2</sup>

*A key part of the process for Dodd-Frank is asking the right questions. Do we need to improve our organization around assessing the impact of Dodd-Frank? Did we miss any issues in our review and analysis of the Act? Are we failing to consider the interactions between several issues? Are the priorities we established the right ones and what has changed since we first established those priorities? Are we taking advantage of opportunities to influence the regulatory process, including through the industry associations or groups to which we belong? Should we involve our congressperson or senator in issues where further legislative clarity on intent or even curative provisions may be required? While the new laws present challenges, are there opportunities to be gained as well? Firms are considering these and many other questions constantly as they assess the potential impacts and their responses to Dodd-Frank.*

### **Derivatives regulation**

*“If we don’t change direction soon, we’ll end up where we’re going.”*

—Professor Irwin Corey

By any measure, the Commodity Futures Trading Commission (CFTC) has been amazingly prolific in proposing rules to comprehensively regulate over-the-counter swaps markets under Title VII of Dodd-Frank. The SEC also has issued proposed rulemakings (although fewer in number) to oversee the smaller security-based swaps markets. Timing and resources are key constraints in the efforts to weave and implement a cohesive and comprehensive regulatory framework that provides a practical basis for achieving the legislative goals of greater transparency, accountability, and risk management for centrally cleared and bespoke over-the-counter derivatives contracts. The complexity of the emerging framework also may raise uncertainty with respect to implementation timing and costs for all participants.

The sheer number of proposed swap regulations issued makes it easy to focus on each tree proposal and get lost in the regulatory forest. The CFTC divided its implementation task into 30 topics and since August has proposed one or more rulemakings at a drumbeat pace in all but two of these topic areas. The net result is that many details regarding how the CFTC proposes to regulate swaps markets are available now in varying degrees of

<sup>2</sup> <http://www.sec.gov/news/speech/2011/spch020411ebw.htm>.

specificity. This does not mean, however, that the proposals present the complete or final regulatory regime. Industry and congressional response has at times been loud and often critical. Changes to the proposals should be expected, as the CFTC and, to a certain extent, its agency partners continue to follow an especially interactive rulemaking process that is marked by scores of meetings, thousands of comment letters, and extensive interaction with interested parties. Important topics remain, such as the swaps definition and margin and capital requirements. Similarly, entities that will serve as utilities in the new regulatory framework require final guidance and time to establish their rules, infrastructure, capacity, and information-processing protocols for the new operating environments contemplated by the law.

To understand this monumental effort to build a new regulatory structure within a year of enactment over a market with an estimated notional value of \$600 trillion, it helps to evaluate three overlapping categories: registered swap entities, other swap counterparties, and swap transactions.

**Registered swap entities.** Dodd-Frank creates several new registered swap entities that perform various functions, including swap dealers, major swap participants (MSPs), swap execution facilities (SEFs), and swap data repositories (SDRs). These registrants join re-tasked existing futures market participants, such as designated contract markets, derivatives clearing organizations, futures commission merchants, introducing brokers, commodity trading advisors, and commodity pool operators. Although these new registrants will perform different functions in the swaps marketplace, each type must operate under a complex of proposed standards that govern matters such as registration, business conduct, financial resources, compliance, recordkeeping, and reporting.

The proposals defining swap dealers and MSPs present significant issues for financial and commercial swap market participants, not the least of which are possible registration requirements. Financial entities need to address new regulatory divides across their lines of business and identify costs, benefits, and strategic opportunities. The swap dealer and MSP definitions also may impact commercial or nonfinancial firms with large swap books, particularly agriculture, manufacturing, and energy companies. Their previously unregulated or holistically supervised swap activities may trigger entity- or division-based regulation, or at least the continuous obligation to check. In all cases, there is or will be a reporting obligation incumbent on at least one party to a swap transaction, irrespective of whether it is centrally cleared.

**Other swap counterparties.** All swap counterparties face numerous choices and regulatory duties. In order to assess this regulatory impact, these counterparties should inventory and examine their swap positions across business lines. They must develop plans and capacity for tracking and reporting pre- and post-trade data throughout the life of each swap. They must consider regulatory characterization of the purpose for entering each swap trade and put (automated) processes in place for regulatory monitoring of the swap through termination or settlement.

**Swap transactions.** On a transaction-specific basis, Dodd-Frank contains a preference for centralized clearing of swaps. Detailed regulatory requirements will apply to the execution, clearing, reporting, and recordkeeping for all swaps under the current proposals. Standardized swaps will be subject to mandatory execution and clearing through registered entities, unless an exemption applies. The proposals offer clarification of important “outs” such as the exception from clearing provided to nonfinancial entities (popularly termed “commercial end-users”) that use swaps to hedge or mitigate commercial risk. However,

providing these exemptions adds complexity to the clearing and execution of swaps, particularly among counterparties engaged through unified netting agreements that will require separation for clearing and settlement of centrally cleared and bilateral trades. This issue is even more challenging for those swap counterparties to agreements that accommodate multi-product netting.

Two linchpin rules remain missing: the definitions of “swap” and “security-based swap” and standards for imposing capital and margin requirements on swap transactions and swap counterparties. Without these proposals, no one can fully assess the true impact of the proposed swap regulatory regime. Controversy over these highly anticipated regulations, and the speed and scope of proposals issued, has captured the attention of the House Financial Services Committee, which recently conducted an oversight hearing. Notwithstanding considerable and varied public debate, a consensus among the regulators and others appears to be emerging in certain key areas:

1. Swaps used by commercial end-users to hedge or mitigate commercial risk should not be subject to margin or capital requirements.
2. Most swap rules will not become effective before September 2011, and compliance will phase in.
3. Regulation to promote transparency and reduce risk is necessary.

Many practical implementation and cost concerns remain pending the clarification and formalization of the consensus for these key aspects.

Also pending is (i) the US Treasury Department’s determination of how foreign exchange activities will be treated in the context of such rules, (ii) the respective functional supervisors’ rules for “push-out” of certain swaps activities from financial institutions that may receive federal assistance, and (iii) the margin requirements for derivatives transactions of regulated swap entities with their affiliates.

Two practical, extra-regulatory issues also will shape swap regulation going forward. First, budget battles in the politically split Congress threaten to limit funding for the CFTC and SEC to levels that would hamper their ability to effectively conclude on the rules by the effective dates mandated in the Act and be prepared to regulate once the new regime is final. Funding for staff and technology that could streamline the regulatory processes is ensnared in a larger US deficit-cutting battle. As a result, the agencies may rely more on self-regulatory organizations or fee-based revenue to address these shortfalls, wherever possible, and market participants may face delay in getting required regulatory approvals.

Second, international derivatives regulation is out of step with Dodd-Frank. No major economy other than Japan regulates swap transactions in any meaningful way. This creates tension between the regulatory desire to prevent evasion and the industry imperative to seek least-cost business solutions. In particular, many firms engaged in swaps activities internationally seek clarity—perhaps through international regulatory protocols or experience with implementation of the new rules—to understand the coverage of US swaps regulation on global businesses. This dichotomy should change over time as other jurisdictions, particularly the European Union, continue to progress toward imposing a swap regulation regime that follows the transparency, market integrity, and systemic risk goals targeted by Title VII of Dodd-Frank.

*The overriding question through this initial period of extensive regulatory proposals is whether the new system will work as intended to foster transparency, reduce overall systemic risk, support American competitiveness, be more efficient, facilitate price discovery, and serve the needs of both key participants and end users.*

## **Systemic risk: are you a SIFI?**

*“Risk is a part of God’s game, alike for men and nations.”*

—Warren Buffet

Dodd-Frank embraces macro-prudential regulation—the regulation of financial institutions on the basis of their importance to the financial system. In embarking on this new type of regulation, Dodd-Frank defines three categories of systemically important financial institutions (SIFIs).

**Large bank holding companies and foreign banks with US branches or bank subsidiaries.** If a bank holding company (BHC) or a foreign banking organization (FBO) with US branches or agencies or US bank subsidiaries has consolidated assets of \$50 billion or greater, it is also defined by the Act as a SIFI. (For FBOs, it has yet to be finally determined whether the amount is based solely on US assets.)

**Nonbank financial companies designated as SIFIs by the FSOC.** A great deal of concern has been generated among the affected parties regarding what criteria the FSOC will use and weigh in determining whether to designate a nonbank financial firm as a SIFI. In January, the FSOC released a notice of proposed rules regarding its authority to designate certain nonbank financial companies as SIFIs. On February 8, the Federal Reserve Board (FRB) requested comment on a proposed rule to define when a nonbank company is “predominantly engaged” in financial activities and thus eligible for SIFI designation under Dodd-Frank. The proposed rule also defines the terms “significant nonbank financial company” and “significant bank holding company,” which relate to the factors the FSOC must consider in determining whether to designate a nonbank financial company for SIFI supervision and apply to it the credit exposure reporting requirements for FSOC-designated nonbank SIFIs and BHC SIFIs.

A staff committee working under the FSOC has segmented the nonbank sector into four broad categories: (1) the hedge fund, private equity firm, and asset-management industries; (2) the insurance industry; (3) specialty lenders; and (4) broker-dealers and futures commission merchants. The FSOC has begun developing measures of potential risks posed by these firms. It is expected that the FSOC will make its initial designations on nonbank financial SIFIs shortly after final rules are adopted in early spring.

**Financial market utilities designated as SIFIs by the FSOC.** The FSOC issued an advance notice of proposed rules in December seeking input on the criteria and analytical framework to be used in designating a financial market utility (FMU) as systemically important. The definition of FMU includes any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person. The FSOC is expected in the near future to issue a proposed rule regarding the FSOC’s authority to designate FMUs as systemically important. Of special significance to such designation is that Dodd-Frank empowered the FRB to provide collateralized liquidity in unusual and exigent circumstances to FMU SIFIs.

## ***The costs of SIFI status***

For the first two categories—BHC/FBO and nonbank SIFIs—the FRB within the next six months will be requesting comment on a proposed rule or rules incorporating the following specified “enhanced prudential standards” from Dodd-Frank for such SIFIs: (i) risk-based capital and leverage requirements, (ii) liquidity requirements, (iii) risk-management requirements, (iv) credit exposure limits, (v) risk committee requirements for the boards of each publicly traded nonbank SIFI and for publicly traded BHCs with \$10 billion or more in assets, (vi) stress tests conducted by the FRB, and (vi) company-conducted stress tests.

For the FMU SIFI category, the FRB will be proposing rules on (i) risk-management standards for FMU SIFIs supervised by the FRB, and (ii) when an FMU SIFI supervised by the FRB must provide advance notice of a proposed material change to its rules, procedures, or operations.

Other SIFI-related initiatives likely to occur in the next six months include:

- A proposed rule to implement the requirement that nonbank SIFIs and BHC SIFIs provide the FRB written notice prior to acquiring a nonbanking company with assets of \$10 billion or more for which the FRB must consider the effect of the acquisition on financial stability.
- A request for comment by the FRB on a proposed rule to prescribe the forms and information requirements for nonbank SIFIs to register with the FRB.
- A proposed rule, developed jointly with the Federal Deposit Insurance Corporation (FDIC), to require nonbank SIFIs and BHC SIFIs to report to the FRB, FSOC, and FDIC on the credit exposures between the company and other “significant” nonbank financial companies and BHCs.
- A proposed rule, developed jointly with the FDIC, to implement the “living will” requirements for nonbank SIFIs and BHC SIFIs not already subject to the recovery and resolution planning process.
- A request for comment by the federal financial regulatory agencies on a proposed rule to implement concentration limit that prohibit a financial company from making an acquisition if the liabilities of the combined company would exceed 10 percent of the liabilities of all financial companies. This limit was the subject of a separate FSOC report in January and can be viewed as a way to ensure no SIFI gets too large and add to overall systemic risk.

For FBOs, Dodd-Frank requires the FRB in applying BHC SIFI standards to FBOs to take into account the principles of national treatment and equality of competitive opportunity and the extent to which the FBO is subject on a consolidated basis to home-country standards comparable to those applied to US financial companies.

*A number of nonbank financial companies are conducting a preliminary assessment of their chances of being designated as SIFIs by focusing on some obvious markers under the guidance that exists:*

- *Is my firm predominantly engaged in financial activities or, if a commercial firm, do I have a large (\$50 billion or greater) subsidiary predominantly engaged in financial activities?*
- *What are the key metrics for assessing systemic importance in my industry/lines of business?*

- *If I were a member of the FSOC, what criteria would I find convincing in reviewing my organization?*
- *What types of external or internal events could cause my firm to experience financial distress?*
- *If my firm experienced financial distress, would its problems have a concentrated impact on large, potentially systemic firms or on markets where it holds a significant if not dominant market share?*

*These and other questions are being explored, and institutions may wish to have the information in hand to respond.*

## Changes to the bank regulatory and supervisory framework

*"I saw a bank that said '24 Hour Banking,' but I don't have that much time."*

—Steven Wright

### *Thrifts and thrift holding companies*

In January, the four federal banking agencies issued a Joint Implementation Plan for the transfer of OTS personnel, authority, responsibilities, funds, and property to other agencies. Of principal interest to thrifts and thrift holding companies are those sections of the plan describing the transfer of key regulatory, supervisory, examination, and reporting requirements.

**Office of the Comptroller of the Currency (OCC).** The OCC's objective is to fully integrate OTS staff and functions into the current OCC organization's structure and supervisory model. This will affect approximately 670 federal thrifts. The vast majority of thrifts will be supervised by the OCC's community bank supervision function; larger thrifts will be supervised by the mid-sized and large bank supervision programs. The special supervision program will be expanded to include troubled thrifts. The OCC has been working with the OTS to review all of the OTS regulations governing federal thrifts, and anticipates some changes will be effective on July 21, 2011.

**FDIC.** As of the date of enactment, there were 61 state-chartered thrifts supervised by the OTS. The OTS will continue to have responsibility for examinations of these institutions to occur before July 21, 2011. Thereafter, the FDIC will fully integrate the supervision of state thrifts into its supervision program. State thrifts can be absorbed by the appropriate FDIC regional offices.

**FRB.** Dodd-Frank transfers authority for consolidated supervision of thrift holding companies and their non-depository subsidiaries to the FRB effective July 21, 2011. The FRB will carry out its supervisory oversight of thrift holding companies consistent with its established approach to holding companies as set forth in SR Letters 08-8 and 08-9. The FRB also has authority to require grandfathered commercial or industrial unitary thrift holding companies (i.e., that own a single thrift) to establish an intermediate holding company over all or a portion of the company's financial activities. Any changes to existing OTS regulations for thrift holding companies will not occur until after July 21, 2011. Similar to the OCC, non-complex thrift holding companies will be supervised in the community banking portfolio while larger, more complex companies will be supervised in the regional or large banking organization portfolios.

On February 3, the FRB, FDIC, OCC, and OTS proposed changes to reporting requirements for thrifts and thrift holding companies regulated by the OTS. The proposed changes would result in uniform reporting systems and processes among FDIC-insured banks and thrifts, as well as uniform reporting requirements among all holding companies supervised by the FRB.

### **Other bank and BHC supervisory initiatives**

During the initial milestone period, rules were proposed to implement the Collins Amendment, which extends the current capital adequacy framework for insured depository institutions to BHCs, thrift holding companies, and nonbank SIFIs. Rules have also been proposed to modify the market-risk capital rules to take into account Dodd-Frank changes.

Over the next several months, a number of other bank or BHC supervisory initiatives under Dodd-Frank will be proposed or made final, including:

- requiring a BHC (as well as its subsidiary depository institutions) to be well-capitalized and well-managed in order to qualify as a financial holding company;
- permitting a limited-purpose credit card bank to make corporate credit card loans to small businesses; and
- prohibiting incentive-based compensation arrangements that encourage inappropriate risk-taking by covered financial companies, and requiring the disclosure and reporting of certain incentive-based compensation information by covered financial companies. The FDIC recently approved a joint proposed rulemaking on this subject.

*With the handover of OTS regulatory functions to the OCC, FDIC, and FRB less than six months away, thrifts and thrift holding companies should be assessing (i) what these supervisory changes may mean in terms of the scope and conduct of examinations and supervision, and (ii) the strategic importance of the new regulatory framework, which has eliminated several advantages that thrifts and their holding companies have previously enjoyed, including the loss of field preemption to a case-by-case approach and the requirement that thrift holding companies be subject to capital requirements by 2015.*

### **The Volcker Rule**

*“What’s the subject of life—to get rich? All of those fellows out there getting rich could be dancing around the real subject of life.”*

—Paul Volcker

**Divestiture conformance periods.** After issuing a notice of proposed rules in November, the FRB recently issued a final rule to implement the conformance periods available to banking entities under the Volcker Rule, which prohibits such entities from engaging in proprietary trading and from investing in, sponsoring, or having certain relationships with hedge funds or private equity funds. The rule gives parameters and procedures for qualifying for the standard two-year exemption (plus three one-year extensions) and for the five-year extension for investments in illiquid funds.

**FSOC study.** Released in January, the FSOC’s study and recommendations with respect to the Volcker Rule grapple with the dilemma of determining when permissible activities that involve acting as principal—market-making, hedging to mitigate risk, and underwriting—

cross some threshold and become impermissible proprietary trading. To deal with this and other challenges, the study recommends a robust “programmatically compliance regime” that includes internal policies and procedures, internal quantitative and other controls, recordkeeping and reporting systems, independent testing, and board of directors and CEO accountability (the latter in the form of a public certification to the compliance regime’s effectiveness).

In furtherance of compliance, the study recommends that the agencies involved require banking entities to report on quantitative metrics that may assist in identifying impermissible activities. The FSOC noted four “promising categories” of such quantitative metrics, including (i) revenue-based metrics, (ii) revenue-to-risk metrics, (iii) inventory metrics, and (iv) customer-flow metrics. In terms of a methodology for analyzing quantitative metrics, the study recommends that the agencies require banking entities to have sufficient resources for the application and testing of these metrics via cross-industry review, firm-specific operating experience, and comparisons to stand-alone proprietary trading operations.

During the next several months, the financial regulatory agencies will propose rules to implement the Volcker Rule activity restrictions of Dodd-Frank, which will no doubt include or offer as alternatives many of the recommendations that emerged from the study.

*The Volcker Rule presents major interpretive challenges, as acknowledged in the FSOC’s recently issued study and recommendations. In developing their inventories of possible impacts, it is important for affected institutions to consider all possible alternative interpretations of the Volcker provisions.*

## **Insurance regulation and insurers under Dodd-Frank**

*“I don’t want to tell you how much insurance I carry with my insurance company, but all I can say is: when I go, they go too.”*

— Jack Benny

While some industry observers view Dodd-Frank’s impact on insurers as muted—a view that seemed to bear out during its first six months, which saw little direct activity on insurance regulation—the Act could nonetheless have a profound impact on individual firms, depending on the nature, size, and structure of their business and the development and application of future rules. Additionally, although Dodd-Frank did not supplant the authority of the states to regulate the business of insurance at a functional level (as prescribed under the McCarran-Ferguson Act of 1945), it did introduce a new layer of federal, macroprudential supervision that could impact some insurers.

**Federal Insurance Office.** Dodd-Frank established the Federal Insurance Office (FIO) within the US Treasury, creating a new federal presence in the broader oversight of insurers. A yet unnamed director-level appointee of the Treasury secretary will head the office. As authorized under the Act, a number of Treasury Department officials and staff are already working on implementing the Act’s FIO provisions. While functional regulatory authority remains within the dominion of the states, the FIO effectively has two primary purposes:

1. To gather and analyze information on insurers in order to inform the federal government of their systemic significance. The FIO can recommend to the FSOC that an insurer be considered a nonbank SIFI.

2. The FIO, representing the Treasury, will share joint authority with the US Trade Representative (USTR) to negotiate and enter into international “covered agreements” with foreign nations on behalf of the US. When these relate to the business of insurance, *they must achieve a level of protection of insurance or reinsurance for consumers that is substantially equivalent to the protection achieved under state law.* In other words, the FIO/USTR would not be able to enter into agreements that create a regulatory standard that would be deemed less rigorous than current state law.

In addition to the above, another of the FIO’s significant statutory responsibilities is to report to Congress no later than January 2012 on how to modernize and improve US insurance regulation. This one-time study will examine the efficacy and uniformity of state insurance regulation.

**Nonbank SIFI designation.** The director of the FIO is authorized to recommend to the FSOC that an insurer or affiliates thereof be designated as a nonbank SIFI. The director is a non-voting member of the FSOC, as is a current state insurance regulator, Director (Commissioner) John Huff of Missouri, whom the National Association of Insurance Commissioners (NAIC) membership chose for a two-year term. The only voting member with insurance expertise is an independent member, who has yet to be appointed by the president. While the FIO director has authority to recommend SIFI status for an insurer, it is unclear whether the FSOC can act on its own without the FIO director’s recommendation. Recently, a number of Members of Congress wrote the President and Treasury Secretary Geithner urging appointment of the FIO Director especially given the importance of his or her role in providing input on SIFI designations, the Volcker rule and other key issues. If designated a nonbank SIFI, an insurer would be subject to additional federal regulation by the FRB that is intended to be more stringent than current regulation of other insurers, with all the enhanced prudential standards for SIFIs theoretically in play. However, Dodd-Frank confers substantial discretion on the FSOC and FRB to take into account industry differences (including differences in regulation) when applying heightened standards.

**Insurers that are bank or thrift holding companies.** Insurers that own banks or thrifts and which are BHCs or thrift holding companies are subject to the proprietary trading prohibitions of the Volcker Rule, but are provided with an exemption for proprietary trading activities conducted for the general account if certain conditions are met. Such BHC and thrift holding company insurers are also subject to the hedge fund and private equity fund prohibitions of the Volcker Rule; however, the Volcker Rule provides that a designated nonbank SIFI is subject to additional capital charges in lieu of the prohibitions. What is not clear is whether this would apply to a designated nonbank SIFI insurer that is a thrift holding company.

With the transfer of OTS duties to the OCC, FRB, and FDIC effective July 21, 2011, insurers that are thrift holding companies will be subject to regulation by the FRB, which has indicated that it will use its consolidated BHC model, including for reporting. Insurers that own only trust thrifts have the option of being exempted from thrift holding company status if, as of the transfer date and thereafter, they continue to limit their thrift to engaging in trust and fiduciary activities. When examining bank holding companies and thrift holding companies, the FRB is required to rely on and coordinate its activities with other regulators, including state insurance regulators.

The Collins Amendment’s minimum capital requirements will also require thrift holding companies to meet bank capital requirements by 2015, a major and perhaps complicated shift in regulation for insurers that own thrifts.

*A major challenge faced by insurers at the federal level is that federal regulators have very little experience dealing with insurance regulation and how it is conducted at the state level. While the new FIO can play an important role in that effort, the speed with which Dodd-Frank is moving requires insurers to be proactive in educating the FSOC and federal regulators with their views on nonbank SIFI designation and regulation and the impacts of the Volcker Rule and BHC-style regulation, reporting, and capital requirements, among other issues.*

## Investor protection

*“A rich man is nothing but a poor man with money.”*

—W. C. Fields

In a recent speech, SEC Chairman Mary Schapiro noted the SEC’s current Dodd-Frank tally: the Commission has proposed 24 rules, adopted six final and two interim rules, and approved two proposals from the self-regulatory organizations. That doesn’t include the two major reports recently submitted by the SEC staff to Congress on investment adviser examinations and a uniform fiduciary standard for broker-dealers and investment advisers.

Dodd-Frank requires the SEC to stretch to create a new oversight structure for previously unregulated firms and activities: OTC derivatives dealers and major swap participants in security-based swaps and advisers to hedge funds and private equity funds. This in itself is a tall order, but the commission must also fulfill its new mandates to oversee systemic risk and create a new whistleblower program to incentivize those with information to come forward to the SEC (with the possible award of a bounty payment ranging from 10 percent to 30 percent of any penalties or disgorgements of \$1 million or more). In addition to its Dodd-Frank rulemaking, the SEC has also recently focused on its enforcement efforts, seeking to restore its historic reputation as a proactive enforcer.

## Securitization and credit rating agencies

*“A little more moderation would be good. Of course, my life hasn’t exactly been one of moderation.”*

—Donald Trump

One of the SEC’s early post-Dodd-Frank rules was to require any issuer registering the offer and sale of an asset-backed security (ABS) to perform a review of the assets underlying the ABS and to disclose the nature, findings, and conclusions of this review. At the same time, the SEC adopted new rules related to representations and warranties in ABS offerings (e.g., fulfilled and unfulfilled repurchase requests). Nationally recognized statistical rating organizations (NRSROs) are also required to provide information regarding the representations, warranties, and enforcement mechanisms available to investors in an asset-backed securities offering.

The federal financial regulatory agencies are developing joint proposed rules that are expected in the near term to implement the credit risk retention requirements—the so-called “skin in the game” rules for asset-backed securities. Rules must require any securitizer to retain at least 5 percent of credit risk in assets it transfers through a securitization, with an exception for securitizations backed by qualified (low-risk) residential mortgages.

Dodd-Frank also contains substantive new requirements for credit rating agencies, including imposing a new liability standard, mandating internal controls and changes in governance, imposing specific provisions to address conflicts of interest, increasing SEC oversight specifying new disclosures, and removing the use of ratings in many government regulations. The Act also requires the SEC to conduct three studies relating to credit rating agencies. In December, the SEC requested comment on the feasibility and desirability of standardizing credit rating terminology. In addition, two studies are required on NRSROs, one on alternative compensation models for rating structured finance products and a second on NRSRO independence.

On February 9, 2011, the SEC proposed to remove references to credit ratings in rules and forms under the Securities Act of 1933 and the Securities Exchange Act of 1934, and asked for comment on the impact on issuers and other market participants, and whether there are alternatives that should be considered. In her February 17 testimony before Congress on the first six months of Dodd-Frank, FDIC Chairman Sheila Bair acknowledged that the federal banking agencies (which had earlier proposed similar changes required by Dodd-Frank) were having difficulty in finding adequate substitutes for credit ratings. Testifying before Congress on the same day, Acting Comptroller of the Currency John Walsh noted that amending the Act in a “targeted manner that allows institutions to make limited use of credit ratings” could reduce implementation concerns.

### ***Registration as advisers: new duties for broker-dealers?***

“Change before you have to.”

—Jack Welch

The SEC took steps to implement Dodd-Frank’s requirement that advisers to private funds—previously exempt from registration—become registered as advisers by July 21, 2011. Thousands of firms will need to register, including advisers to hedge and private equity funds, and approximately 4,100 investment advisers (with less than \$100 million in assets under management) will switch from SEC to state registration. Registration will entail new obligations, including having a compliance program, undergoing examinations, and submitting to other oversight. The SEC also proposed two sets of new rules requiring advisers to private funds to submit new information to the SEC and to the FSOC. These rules are expected to be adopted in coming months—and the July 21 deadline for registration appears to be a hard line in the sand.

The SEC also proposed a permanent registration regime for municipal advisors who provide advice to state and local governments and other borrowers involved in the issuance of municipal securities, or with respect to the investment of governmental monies. Under the proposal, municipal advisors would have to register with the SEC, undergo examinations, and submit more detailed information than is currently required. This proposal would supplant a temporary registration rule issued in October to meet Dodd-Frank’s effective date.

In addition, the SEC published its staff’s study recommending a uniform fiduciary standard for broker-dealers and advisers when providing personalized advice about securities to retail customers. Many questions exist about the impact and implications of these recommendations and firms will want to start considering these issues now.

*Prior to registration as investment advisers for private funds or registration as municipal advisers under the SEC's permanent regime, firms should undertake a comprehensive review of their operations to meet needed enhancements to controls and disclosures. Important steps include identifying conflicts of interest, implementing a tailored compliance program, designating a competent chief compliance officer, drafting clear and accurate registration documents, and ensuring that newly required records will be created and maintained consistent with books and records requirements.*

## **Disclosure**

*“Did you ever hear of a kid playing accountant—even if they wanted to be one?”*

—Jackie Mason

Dodd-Frank is impacting the disclosure requirements of public companies in both the financial services industry and non-financial sectors. For example:

**Risk factor disclosures.** Companies will need to consider risk factor disclosures in their 10-K and 10-Q filings to ensure they provide requisite details concerning the impact of Dodd-Frank—specifically, the timing and extent of the relevant business, operational, governance, and compliance risks, as well as the possible impacts to personnel retention or attraction, and also describing any relevant differences between US and non-US businesses. Where relevant, companies may want to consider disclosure of the risk of being designated as systemically important (particularly the potential impact on capital reserves and the interaction with Basel II and III requirements) and implications of being designated as a swap dealer or MSP (including the potential impact on capital and liquidity).

**Proposed liquidity disclosures.** Although not mandated by Dodd-Frank, the SEC has proposed enhanced disclosures that would require all public companies to provide additional information about short-term borrowings. Similar to those required under Industry Guide 3 for banks, they are intended to improve liquidity and capital resources disclosures in the management discussion and analysis (MD&A). The proposal requires more frequent disclosures for “financial companies,” which the SEC defined by taking into account similar definitions in Dodd-Frank.

**Specialized disclosure: conflict minerals reporting.** While Dodd-Frank is predominantly focused on financial regulatory reform, it also includes special disclosure requirements that are designed to achieve other public policy objectives. Among them is a provision requiring new disclosures related to the use of “conflict minerals.” This provision has not received a lot of attention to date, but is expected to impact a large population of public companies.<sup>3</sup> The proposed rules will require new procedures and disclosures by all issuers, domestic and foreign, who use so-called “conflict minerals” in their products or manufacturing processes—a group that includes technology, telecommunications, aerospace, automotive, electronics, industrial products, and jewelry manufacturing. Separate provisions of Dodd-Frank require disclosures on mine safety and for resource extraction issuers to make annual disclosures on payments to governments for the purpose of commercial development of oil, natural gas, or minerals.

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<sup>3</sup> By the SEC's own estimate, roughly 6,000 public companies may be subject to these new provisions.

**Say-on-pay and golden parachute disclosures.** Shareholders have more decisions to make in the 2011 proxy season as the new “say-on-pay” votes mandated by Dodd-Frank begin for all public companies (effective as of January 21, 2011). The requirement to include a non-binding, advisory shareholder vote on executive compensation at least once every three years reflects Dodd-Frank’s focus on enhancing corporate responsibility and providing shareholders with a stronger voice on governance matters. On February 2, the SEC published its final rule requiring companies to comply with the golden parachute compensation shareholder advisory vote and disclosure requirements in proxy statements filed on or after April 25, 2011. It also approved a temporary exemption for smaller reporting companies.

### ***Still to come: more executive compensation disclosures and “clawback” rules***

A topic that has received extensive focus in the “Wall Street vs. Main Street” debate has been the relationship between executive compensation and a company’s financial performance, and the vast discrepancies between CEO pay levels and those of rank-and-file employees.

Dodd-Frank directs the SEC to adopt rules requiring public companies to disclose the relationship between executive compensation actually paid and the company’s financial performance, as well as internal pay equity or the so-called “CEO pay ratio”—comparing the total annual compensation of the CEO to the median total annual compensation of all employees. There are significant questions and challenges associated with these disclosures. The SEC has tentatively scheduled proposed rulemaking for the second half of 2011.

In addition, Dodd-Frank significantly expands compensation “clawback” requirements first introduced under the Sarbanes-Oxley Act by requiring payback from current or former executive officers of any compensation awarded erroneously in the three years prior to an accounting restatement, with no consideration regarding the presence or absence of misconduct. Many questions are still to be answered regarding implementation. Proposed rulemaking is tentatively scheduled for the second half of 2011, and the SEC will be looking for input from companies and other stakeholders.

*While Dodd-Frank was aimed at corporate abuses and risk-taking in the financial industry, in many cases it applied disclosure and other remedies across the board as a matter of corporate reform. Specific provisions on conflict minerals, resource extraction, and mine safety were added even though they had no relation to the financial crisis. These types of provisions continue trends in expanding the scope of disclosures to include matters pertaining to broader social or political agendas, and present their own challenges in collecting, assessing, and disclosing the information in ways that meet requirements not typically found in financial and business disclosures.*

### ***Deposit insurance***

*“Government’s view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it.”*

—Ronald Reagan

On February 7, the FDIC adopted a final rule pertaining to the deposit insurance assessment base, and including assessment rate adjustments, deposit insurance assessment rates, dividends, and large bank pricing methodology. Many of the changes were made as a

result of provisions of Dodd-Frank that are intended to shift more of the funding for the FDIC to larger banks. There will be no FDIC dividends for the foreseeable future, but assessment rates will adjust downward as the FDIC's deposit reserve ratio increases. For large-bank pricing, the FDIC will use a scorecard combining CAMELS ratings with financial performance and loss severity scores. Except for the future assessment rate schedules, all changes go into effect April 1, 2011.

**Assessment base.** As required by Dodd-Frank, the base for deposit insurance assessment purposes is defined as average consolidated total assets during the assessment period less average tangible equity capital during the assessment period. Average consolidated total assets are defined in the quarterly call reports, using a daily averaging method. Tangible equity capital is defined as Tier 1 capital and will be calculated monthly.

**Rate schedule.** The FDIC adopted a new rate schedule effective April 1, 2011, and suspended dividends indefinitely; however, in lieu of dividends, and pursuant to its authority to set risk-based assessments, it also adopted progressively lower assessment rate schedules that will take effect when the reserve ratio exceeds 1.15 percent, 2 percent, and 2.5 percent. Risk categories and the use of long-term debt issuer ratings for large insured depository institutions (IDIs) and large IDIs that are structurally and operationally complex or that pose unique challenges and risk in the case of failure (highly complex IDIs) have been eliminated. A large IDI will continue to be defined as it currently is (generally, an IDI with at least \$10 billion in total assets). In general, a highly complex IDI will be an IDI (other than a credit card bank) with more than \$50 billion in total assets, and that is controlled by a parent or intermediate parent company with more than \$500 billion in total assets or a processing bank or trust company with at least \$10 billion in total assets.

**Scorecards.** The FDIC will combine CAMELS ratings and certain financial measures into two scorecards, one for most large IDIs and another for the remaining large, highly complex IDIs. Each scorecard assesses risk measures to produce two scores—a performance score and a loss severity score—that will be combined and converted to an initial assessment rate. The performance score measures an IDI's financial performance and its ability to withstand stress. The loss severity score quantifies the relative magnitude of potential losses to the FDIC in the event of an IDI's failure. Once the performance and loss severity scores are calculated, these scores will be converted to a total score. The FDIC will have the ability to adjust the total score of a large IDI or highly complex IDI by a maximum of 15 points, up or down, based upon significant risk factors that are not captured in the scorecard. The FDIC will use a process similar to the current large bank adjustment to determine the amount of any adjustments. The FDIC will seek comment on updated guidelines on the large bank adjustment process, and will not adjust assessment rates until the updated guidelines are approved by the FDIC board of directors.

*Nearly all of the 7,600-plus IDIs with assets less than \$10 billion will pay smaller assessments as a result of this final rule. The combined effects of changes will result in 59 large institutions paying lower dollar assessments and 51 large institutions paying higher dollar assessments. Many of these latter large institutions will experience significant changes in their overall assessments, according to FDIC Chairman Sheila Bair.*

## Consumer protection

*“Big business never pays a nickel in taxes, according to Ralph Nader, who represents a big consumer organization that never pays a nickel in taxes.”*

—Dave Barry

Two major consumer protection issues have dominated during the initial milestone period:

- What will the new CFPB look like, and who will be its director?
- Will the FRB be willing to change its original debit fee interchange fee proposal? And if not, will Congress get into the picture?

### **The CFPB**

In a letter dated January 10, 2011, the inspectors general for the Treasury and the Fed responded to a series of questions posed by House Financial Services Committee Chairman Spencer Bachus and House Subcommittee on Insurance, Housing and Community Opportunity Chairman Judy Biggert on Treasury’s activities to establish the CFPB. The letter sheds some helpful light on the organization of the CFPB, its authority, and its priorities.

**Scope of CFPB authority without a director.** Even if the CFPB does not have a Senate-confirmed director by July 21, 2011, it is Treasury’s view that it nonetheless can perform all authorities it is granted except (i) prohibiting unfair, deceptive, or abusive acts or practices; (ii) prescribing rules and required model disclosure forms; (iii) prescribing rules relating to the filing of limited reports for the purpose of determining whether a nondepository institution should be supervised; and (iv) supervising or examining nondepository institutions.

**Organization structure.** The CFPB implementation team currently has a draft plan of its organizational structure and a draft budget for fiscal years 2011 and 2012. There will likely be three mission-related directorates: (i) education and engagement, (ii) supervision and enforcement, and (iii) research, markets, and rules.

**Initial priorities.** Professor Elizabeth Warren, Assistant to the President and Special Advisor to the Secretary of the Treasury on the CFPB, has indicated that cost savings, improved regulatory compliance, and simplified consumer disclosures are among the factors being considered in establishing the rulemaking priorities. Professor Warren has offered examples of two policy initiatives that will receive priority: (1) consolidating duplicate and overlapping mortgage disclosure forms mandated by the Truth in Lending Act and the Real Estate Settlement Procedures Act, and (2) simplifying credit card agreements to ensure that customers fully understand fees and finance charges.

### **Debit card interchange fee**

In December, the FRB issued a notice of proposed rules to implement the debit card interchange fee and routing provisions of Dodd-Frank’s Durbin Amendment. Debit card interchange fees are established by payment card networks and paid by merchants to card issuers for each transaction.

The proposed new Regulation II, Debit-Card Interchange Fees and Routing, would establish standards for determining whether a debit card interchange fee received by a card issuer is “reasonable and proportional” to the cost incurred by the issuer for the

transaction. These standards would apply to issuers that, together with their affiliates, have assets of \$10 billion or more. Certain government-administered payment programs and reloadable general-use prepaid cards would be exempt from the interchange fee limitations.

The FRB proposed two alternative interchange fee standards that would apply to all covered issuers—one based on each issuer’s costs, with a safe harbor (initially set at 7 cents per transaction) and a cap (initially set at 12 cents per transaction); the other a stand-alone cap (initially set at 12 cents per transaction). The FRB also requested comment on possible frameworks for an adjustment to the interchange fees to reflect certain issuer costs associated with fraud prevention.

If the FRB adopts either of these proposed standards in the final rule, the maximum allowable interchange fee received by covered issuers for debit card transactions would be more than 70 percent lower than the 2009 average, once the new rule takes effect on July 21, 2011.

The proposed rule would also prohibit all issuers and networks from restricting the number of networks over which debit card transactions may be processed. The FRB is requesting comment on two alternative approaches. One alternative would require at least two unaffiliated networks per debit card, and the other would require at least two unaffiliated networks per debit card for each type of cardholder authorization method (such as signature or PIN). Under both alternatives, the issuers and networks would be prohibited from inhibiting a merchant’s ability to direct the routing of debit card transactions over any network that the issuer enabled to process them.

The proposal, not surprisingly, has proven to be highly controversial, and a number of key legislators have expressed concern that the FRB may have gone too far. With a required effective date in April, action on a final rule or legislation to repeal or modify the rule can be expected in the not too distant future.

## **Conclusion**

*“If you don’t have time to do it right, when will you have time to do it over?”*

—John Wooden

The regulatory agencies charged with implementing Dodd-Frank have already impacted the marketplace by issuing so many regulatory proposals in so short a period of time. Accessibility and participation in the regulatory process is unprecedented, with most agencies welcoming meetings with all parties and/or conducting issue-specific roundtables to maximize public input on many proposals. However, some of these agencies—most notably the SEC and CFTC—face possible budgetary constraints that will make it more difficult for them to stay on the Act’s schedules for implementation, to say nothing about execution of their newly created regulatory duties. Many affected parties, including those not fully favoring the new regulatory environment, support proposals that Congress consider not only the funding increases needed by the agencies, but also extension of the effective dates to stretch compliance with increasingly unrealistic deadlines. Final rules that leave major structural and regulatory uncertainties risk dampening the role of the financial sector in financing growth, mitigating risk, and creating efficiencies that benefit the economy. With all that was accomplished in the first six months, the fact remains that a great many difficult and complex questions and issues still need to be resolved.

While Dodd-Frank will have significant impact on financial regulation, many implementation issues are currently unclear and are subject to the rulemaking processes and various statutorily directed studies. PwC will continue to monitor developments and provide you with updates, which will be available at [www.pwc regulatory.com](http://www.pwc regulatory.com).

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