

A Closer Look

The Dodd-Frank Wall Street Reform and Consumer Protection Act



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Part of an ongoing series

Unfinished business

Dodd-Frank – Entering year two

September 2011

With the one-year anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act) now behind us and with the benefit of a year's experience, we discuss herein what has been accomplished under Dodd-Frank and what is yet to come. As we consider year two, we provide a brief look back and a longer look forward, focusing on the key issues and questions we hear often in the marketplace about Dodd-Frank and its implementation.

Looking ahead, an open question is whether and how the sluggishness of the economic recovery, market volatility, negative investor and public sentiment and political roadblocks on Capitol Hill will impact the financial regulatory reform process in the US and how economic and EU political and financial issues will impact the pace and scope of reform more globally.

Some may argue that the scope and timetables for reform should be accelerated to buttress public confidence in the financial system; some may argue that reform should be delayed and reconsidered because it may tighten the spigot of credit flows needed to generate economic growth; and some may argue that in such a difficult environment, the agencies should weigh ever more carefully the scope and timing of each reform proposed, its relationship to and cumulative impact with other reforms and its likely macroprudential and microprudential impacts on markets, market participants, customers, and the public. We focus on the key issues for year two in the face of these competing sentiments.

“As we move forward, we must also work to ensure that our regulatory framework keeps pace with the evolving global financial system. This report provides key recommendations that will build on the progress we’ve made through the Dodd-Frank Act and further strengthen the resilience of the financial markets and our economy.”
Secretary of the Treasury Timothy Geithner on issuance of the first annual report by the Financial Stability Oversight Council

Dodd-Frank, year one: The framework for reform

In looking back at year one, we acknowledge what has become obvious: implementing all of Dodd-Frank within its myriad and often contemporaneous statutory timelines was a monumental task with significant potential for unintended consequences. As EU Commissioner Michele Barnier said in a speech to the Brookings Institution, in financial services regulation, “technical details matter.” The regulatory agencies, Congress, and affected industries all seem to agree that more time is needed in many areas to get the details right. Beyond that agreement, there remain substantial differences over what Dodd-Frank was meant to do or not to do. Issues have been easy to spot; finding solutions is proving vastly more difficult.

A cause at every corner

To put Dodd-Frank in perspective, the statute attempts to do what no financial regulatory legislation has ever done before: to reform *simultaneously* the various US models of regulation and supervision that historically have been applied to a wide range of different financial institutions and products. This approach grew out of the lack of any clear consensus on what caused the financial crisis of 2008–2009. Regulators, legislators, academics, think tanks, industry, commissions, consumer groups, and the voting public identified a range of contributing factors, virtually all of which were addressed in one fashion or another in Dodd-Frank. And, as often happens in Washington, provisions were added to Dodd-Frank that had nothing to do with the crisis beyond the timing of the legislation. Combine all of this with an equally ambitious and simultaneous effort to reform the financial regulatory systems of the G-20 and the multiplicity of fundamental changes demanded over a short period of time begins to stretch the ability of individuals and institutions to adapt.

“The layering and aggregate impact of both US and global regulatory reforms imposes significant costs not just on the industry, issuers, and investors, but on consumers and the US economy. In the wake of the crisis, it may be tempting to adopt any reform that seems to promote safety, but that would be extremely unwise if the economic costs outweigh the marginal benefits to increased safety. At present, far too little attention is paid to examining potential costs of particular reforms in terms of reduced credit or financial intermediation. And far too little attention is paid to assessing the actual amount of additional safety that particular proposed reforms will achieve. This balance must be taken into account—costs and benefits—for reform to be effective.”
T. Timothy Ryan, Jr. President & CEO Securities Industry and Financial Markets, Association, Congressional Testimony June 16, 2011

Macroprudential regulation: Big regulation for big reasons

The changes mandated by Dodd-Frank are guided by the acceptance of a new regulatory paradigm, macroprudential regulation, which is aimed at ensuring the safety of the financial system as a whole more than the safety of any one institution. Under Dodd-Frank, systemically important financial institutions (SIFIs), either by law or agency designation, are made subject to enhanced prudential requirements because their problems can impact financial markets. The intent of the new requirements is to limit market impacts by mitigating risks at, between, and among SIFIs. No SIFI (bank or nonbank) will be too-big-to-fail because it will have left a living will to guide its dissolution — which, worst case, would be managed by a special resolution regime, the Orderly Liquidation Authority.

Left unsaid but becoming more apparent is that macroprudential regulation begets a more macro-focused business model. Recent regulatory guidance issued on stress tests, model risk management, and counterparty credit risk emphasize the need to reassess continually the economic and other market foundations of an institution's business model. The hope is to encourage institutions to take a long-term view based on fundamentals as opposed to what former FDIC Chairman Sheila Bair described as “short-termism” built on maximizing profits from trends that can turn into bubbles with amazing speed.

“A stress testing framework should be sufficiently dynamic and flexible to incorporate changes in a banking organization’s on- and off-balance-sheet activities, portfolio composition, asset quality, operating environment, business strategy, and other risks that may arise over time from firm-specific events, macroeconomic and financial market developments, or some combination of these events.” Interagency Proposed Guidance on Stress-Testing, 76 Fed. Reg. 35079

Rule-writing: Working against the clock with transparency in mind

Much was accomplished in year one by dedicated and overworked agency staff who drafted thousands of pages of proposed and sometimes final rules in an effort to meet compressed statutory deadlines. Regardless of one's views on the regulatory scorecard — the hits, runs, and errors of the regulatory process—it is safe to say, the rule-writing engines were set on high. In the process, the regulatory agencies used many approaches and venues for seeking public input, pursuant to the goal of transparency. There were, of course, the traditional notice-and-comment rulemakings, with comment deadlines frequently extended individually or even en masse in the case of the Commodity Futures Trading Commission (CFTC). Agencies also held scores of meetings with interested parties, all recorded on their websites for public view. Roundtables were held to stimulate discussion of the more controversial proposals and get practical insights. Agency meetings were generally open to the public and often revealed differences of view among agency decision-makers.

Congressional oversight: Constant and comprehensive

Congressional oversight of the Dodd-Frank implementation process began in January 2011 and has not ceased. The Financial Services Committee of the House of Representatives has been especially active. While almost all areas of Dodd-Frank have been explored, special attention has focused on derivatives reform and the new Consumer Financial Protection Bureau (CFPB). These oversight hearings have often been a two-edged sword seeking both transparency and interpretations consonant with different legislative views.

“I am committed to holding rigorous oversight of the implementation process and restoring Americans’ trust in a credible financial services industry.” Sen. Tim Johnson (D-SD), Chairman, Senate Banking Committee, July 26, 2011

“The Dodd-Frank Act is a roadblock to our nation’s recovery. . . . [Congress] should join to fix its provisions that harm our economy . . .” Rep. Spencer Bachus (R-AL), Chairman, House Financial Services Committee, July 10, 2011

Year two: The reality of reform

While year one was challenging in many ways, the majority of truly significant decisions under Dodd-Frank will occur in year two. The heavy regulatory lifting will continue as bank regulators issue final rules on systemic regulation, the Volcker Rule, Living Wills and macroprudential reform; securities and derivatives regulators adopt final rules for derivatives and clearing; and a new federal regulator for consumer finance becomes operational and the first federal office dealing with insurance regulation begins its data-gathering and other missions.

Market participants will continue to seek clarity on individual regulations, adopted piecemeal but implemented *in toto*, and we will start to see the beginning of Dodd-Frank’s cumulative impact as final rules are adopted and implementation begins. As we look ahead at year two, we outline below a number of the key issues and questions we hear frequently in the marketplace that can be viewed as the “unfinished business” of Dodd-Frank.

Banking SIFIs: Awaiting the reform package

The Federal Reserve has stated it will not be imposing the enhanced prudential standards for SIFIs required by Dodd-Frank on a piecemeal basis, but rather will propose a package of coordinated requirements late in the summer of 2011. Many predict the proposals may run to a thousand pages. There have also been indications that requirements will be adjusted for systemic importance — *e.g.*, Federal Reserve Governor Daniel Tarullo indicated that a bank holding company just meeting the \$50 billion SIFI threshold will be regulated more like a non-SIFI bank holding company with \$49 billion of assets than as a much larger and more complex banking organization SIFI.

Although there are some who still believe a SIFI designation is tantamount to a designation as too-big-to-fail which purportedly provides a funding benefit, that view is not shared by those already designated SIFIs by law. Regardless, enhanced standards and other aspects of SIFI status are designed to decrease the likelihood of failure or to blunt the impact of any failure/resolution on the financial markets and the economy as a whole. These mitigants and requirements entail real costs and will influence business models in ways not yet fully appreciated. And if reform stalls at the G-20 level, the specter of US institutions being less competitive in the global markets becomes more real.

“SIFIs will undoubtedly face higher costs as result of being designated. They will very likely face additional reporting and compliance obligations, as well as additional capital charges in the form of a ‘SIFI surcharge.’ For example, the FSB [Financial Stability Board] highlighted ‘supplementary requirements’ for SIFIs, which ‘could consist of a capital or liquidity surcharge linked to the systemic importance of the institution....The IIF [Institute of International Finance] has conducted a study about the costs of SIFI surcharges, and estimates that a 3% surcharge would reduce GDP by about 0.20% over the first two years of implementation. Yet that cost is not evenly distributed across countries; [the] IIF found that Japan could expect only a 0.05% reduction, while the UK could expect a 0.27% reduction. The US was about average.” Hal S. Scott Director of the Committee on Capital Markets Regulation; Nomura Professor and Director of the Program on International Financial Systems at Harvard Law School. (Footnotes omitted). Congressional Testimony of June 16, 2011

SIFI regulation and Basel III: What remains to be done?

Treasury Secretary Timothy Geithner has noted that foremost among the many challenges of reform ahead are those that relate “to capital or leverage requirements and derivatives. It is on these two pillars that the prospect of a truly level global playing field most squarely rests.” Commenting on Basel III, the Secretary said that decisions remained in three important areas:

1. **The “systemic surcharge.”** Still to be determined is the size of the additional requirements — the “systemic surcharge” — that will be imposed on the largest SIFI institutions a/k/a Global SIFIs (G-SIFIs). In deciding on the amount, Secretary Geithner noted the need to consider the impact of other reforms that reduce both the probability of failure of large institutions and the ability of the rest of the financial system to absorb, contain, or diffuse those losses.
2. **Discretionary surcharge.** Still to be determined is how to distinguish between measures that all countries commit to require as a minimum and measures that some countries may choose to impose on top of the systemic surcharge, at their own discretion. Secretary Geithner stated that in the United States, the largest firms will hold an additional surcharge of common equity. However, given the other protections available in the United States, including the Orderly Liquidation Authority, Secretary Geithner stated, “we do not need to impose on top of that requirement any of the three other proposed forms of additional capital — convertible, bail in, contingent capital instruments, or counter cyclical capital requirements.”
3. **Stronger protections.** Secretary Geithner stated that the United States must ensure that it provides a much stronger set of protections to ensure a level playing field in the application of the new Basel III requirements and the additional systemic surcharge.

Living wills: What limits regulatory discretion?

In one of the most significant developments flowing from Dodd-Frank, the Federal Reserve and FDIC are requiring SIFIs to create resolution plans or “living wills.” A failure to cure deficiencies in a living will that had to be resubmitted for approval can result in more stringent capital or other financial requirements or business restrictions. In testimony before Congress, Acting FDIC Chairman Martin Gruenberg stated that the agencies are working to develop a deliberative process for reviewing these plans to determine whether a plan is both “credible” and able to facilitate an orderly resolution of the company under the

Bankruptcy Code. He indicated that careful consideration is being given to the need to keep confidential and proprietary information contained in the resolution plans to the extent permitted by law, to ensure that financial companies provide full and accurate disclosures. Given the wide amount of discretion provided to the Federal Reserve and FDIC to approve these highly confidential plans, what practical recourse will a banking SIFI have if it believes its living will was not fairly assessed? How can some measure of due process and consistency be made part of the process? These and other important issues will be addressed in the final rule the agencies expect to adopt in the near future.

“Although large, complex financial institutions operate globally; their resolution is subject to national legal frameworks. One solution to this problem would be the conclusion of a multilateral treaty that would obligate countries to defer to the resolution decisions of the jurisdiction where the financial institution or group has its main activities. There are examples in other areas of international relations where treaty frameworks have been put in place ... but the adoption of such an approach in the area of financial regulation would not appear to be feasible in the foreseeable future. Given their concerns over financial stability and the potential fiscal costs of bank failure, the authorities of many countries have been unwilling to surrender control over these issues. In these circumstances, the most realistic approach—at least in the medium term—is one that focuses on enhancing co-ordination among national authorities—something that has generally been lacking. Indeed, unless such coordination is achieved, it may be argued that financial stability concerns may require a ‘de-globalization’ of financial institutions so that they fit within the existing local resolution frameworks.”
International Monetary Fund Resolution of Cross-Border Banks—A Proposed Framework for Enhanced Coordination (2011)

Nonbank SIFIs: The designation process

The process by which the Financial Stability Oversight Council (FSOC) will designate nonbank SIFIs under Dodd-Frank is still unclear, leading to much table chatter by industry participants and observers. Early regulatory proposals did little more than repeat the statutory elements. Would institutions be provided with an effective means to contest proposed designations? How would regulation of nonbank SIFIs work in practice? Would it be bank-centric in approach or would it adapt rules created for different types of institutions?

In recent testimony before Congress, Deputy Secretary of the Treasury Neal Wolin indicated that the FSOC is actively engaged in designing criteria and procedures for nonbank designations. He acknowledged that the FSOC had received significant input from interested parties in this rulemaking process in an effort to develop a consistent approach that incorporates both quantitative and qualitative criteria. He further noted that the FSOC plans to provide additional guidance regarding the criteria for designations, guidance that will include specific metrics that will help provide clarity on the FSOC’s evaluation of firms for potential designation, and will outline both the quantitative and qualitative elements of the analytical framework to be used. This will be among the most-watched-for regulatory actions in year two.

The Volcker Rule's proprietary trading ban: Uncertainty continues

The Volcker Rule continued to generate concern and uncertainty through year one. The impending ban on some, but not all, proprietary trading by banks and their affiliates led to preemptive change across certain Wall Street firms, as proprietary trading desks were sold or spun out. The Federal Reserve issued a final regulation defining the conformance period, giving clarity to how long banks will have to abide by Volcker Rule requirements — even though those requirements themselves have yet to be defined.

Per a Dodd-Frank mandate, the Government Accountability Office (GAO) recently issued a study of proprietary trading to look at known risks, potential effects, and regulatory oversight of proprietary trading. The GAO examined concerns among the largest US banking organizations that proprietary trading restrictions could reduce their ability to mitigate risks in other areas, harm their global competitive position, and reduce market liquidity. While the GAO was unable to validate those concerns, it noted the expected: that losses during the financial crisis prompted banking organizations to improve their management of trading risks.

As for the regulators, the GAO found that they faced a number of “challenges” (a word used 19 times in the report) in drawing lines between prohibited proprietary trading and permitted market-making, underwriting, hedging, and customer-driven activities, as well as in obtaining comprehensive data to monitor compliance. This underlines the broader point made by the GAO that “regulations that further define what are and are not permitted activities, could significantly impact the scope of the new restrictions.”

OTC derivatives regulation: Timing isn't everything, but it matters

In year one, the CFTC and the Securities and Exchange Commission (SEC) issued more than 80 sets of proposed rules for new derivatives regulation, clearing, and oversight - an unprecedented number. The pace and volume of rules was driven by Dodd-Frank's Title VII requirement that many regulations and statutory provisions become effective on July 16, 2011. Despite herculean efforts throughout a long year of often coordinated rule writing, both agencies acknowledged in June that they would not meet the statutory deadlines for swaps or security-based swaps. Exemptions were announced permitting business to continue as usual in over-the-counter (OTC) derivatives markets until final rules could be adopted.

This delay is not a true reprieve, however, as the SEC and CFTC will push ahead with final rulemakings. Major proposals on matters such as registration and capital for securities-based swap dealers are still to come. With the regulators on track for releasing many final rules by year-end 2011, serious questions arise about how quickly the industry must conform to the new rules. Among the most important bits of unfinished business in derivatives is the timing of compliance dates, as market participants will need to sequence their implementation. When will classes of activities become regulated, and in what order? When will entities face regulation? Should swap market participants build out their data reporting systems before connecting to clearing agencies? Where to start and what to finish will be key questions in the year ahead. Chairman Gary Gensler stated recently that it was his hope the CFTC would vote on two proposed rulemakings in September seeking additional public comment on the implementation phasing of swap transaction compliance that would affect the broad array of market participants.

Dealers in OTC derivatives: International issues

Questions regarding the scope of the derivatives regulations emerged almost immediately as regulations were proposed. Dodd-Frank states that the CFTC's jurisdiction over swaps will not apply to activities outside the United States *unless* those activities have a "direct and significant connection with activities in or effect on commerce of the United States" or contravene rules or regulations promulgated by the CFTC to prevent evasion. This suggests that entities with global operations could find themselves subject to US regulation for transactions conducted outside or largely outside the United States.

The proposed rules give rise to more questions. The CFTC stated that it would not "generally" require a person to register as a swap dealer if that person's only connection with the United States is as a user of a US-based swaps execution facility, clearinghouse, or contract market. However, the CFTC also said that "a person outside the US who engages in swap dealing activities and regularly enters into swaps with US persons would likely be required to register as a swap dealer." Noting the "global nature of the swap markets and the ability to transfer swap-related risks within affiliated groups" as a concern, the CFTC requested comment on the level of swap dealing that would qualify as having a "direct and significant connection" with activities in or effect on commerce of the United States.

At the SEC, Chairman Mary Schapiro indicated that the agency will deal with the international implications of Title VII "holistically", not piecemeal, and will propose an overall approach to the registration and regulation of foreign entities engaged in cross-border transactions involving US parties in security-based swaps.

"The potential impact of extraterritorial application of US margin rules cannot be overstated, given that adoption of similar rules is at least 18 months away in Europe, with no assurance that the eventual rules will be equally stringent. Thus, for at least the foreseeable future, if a French pension fund, a Dutch company, or an Asian sovereign wealth fund wishes to enter in a derivatives transaction, European or Asian banks will not require them to post margin; if Dodd-Frank is read to require US banks to do so, we will simply lose this business." Barry Zubrow Chief Risk Officer, JPMorgan Chase & Co., Congressional Testimony of June 16, 2011

Treatment of foreign banking and nonbank financial institutions

The general approach of Dodd-Frank to foreign-based financial institutions is one of national treatment. Foreign banks that are bank holding companies, i.e., own US banks, with consolidated assets of \$50 billion or more are defined as SIFIs; in the Living Will regulatory proposal, foreign banks that have consolidated worldwide assets of \$50 billion or greater and that have branches or agencies in the United States are also to be treated as SIFIs. This latter proposed coverage based on worldwide rather than US assets is opposed by the international banking community as contrary to the intent of Congress and unnecessary. This focus on worldwide assets would also produce the unusual result of approximately 98 out of an estimated 124 covered companies for Living Will purposes being foreign banks, including many with relatively small US operations that pose no systemic risk to the United States. Foreign nonbank financial institutions are subject to being designated as SIFIs, depending on the systemic importance of their operations in the United States.

The Volcker Rule includes exemptions that are intended to prevent any extraterritorial application of its prohibitions to the non-US operations of foreign banks that also have US operations; this limitation is consistent with longstanding principles under the International Banking Act. With respect to the regulation of OTC derivatives, foreign financial institutions are urging the CFTC and SEC to provide greater acceptance of the principle of mutual recognition to avoid dual regulation and otherwise to carefully tailor the application of derivatives regulation to situations clearly necessary to protect US customers.

Foreign banking and financial institutions—even more so than US financial institutions—have to pay particular attention to the fine print of the Act and its rules to assess their *de jure* and *de facto* treatment in the implementation process.

Mortgage reform: A tsunami of change

In a May 2011 speech before the Housing Policy Council of the Financial Services Roundtable, Acting Comptroller of the Currency John Walsh said that the extensive changes facing the mortgage lending and servicing industry “will be more tsunami than simple wave.” In particular:

- The mortgage servicing model is under “severe stress”;
- Basel III takes a “highly skeptical view of the value of mortgage servicing rights as bank assets”;
- There are 15 to 20 new mortgage lending requirements in the regulatory pipeline;
- There have been agency enforcement actions against the largest servicers;
- There will soon be comprehensive mortgage servicing standards (the agencies are aiming for year-end);
- The credit risk retention rule will fundamentally change the securitization business;
- Fannie Mae and Freddie Mac are to issue detailed guidelines for mortgage servicing and delinquency management, including financial sanctions for servicers; and
- Other rulemakings are due within 18 months on ability to repay, restrictions on prepayment penalties, and comprehensive new mortgage disclosure.

Given the pace and the number of changes, the Acting Comptroller noted the risk “of drug interactions: you take one pill that’s good for your head, another that helps your heart, but taken together they flatten you.” One regulation may strengthen the quality of capital, another might fix problems with servicing, and yet another may ensure that compensation policies don’t create improper incentives. The acting comptroller noted that “[a]ll of those goals are worthy, but it is hard to predict how they may all work together.”

“The regulation of the mortgage-lending industry is becoming so complex that it threatens to weaken the system instead of curing abuses.” National Association of Realtors, July 22, 2011

Hedge and private equity fund advisers: A new era of oversight

Under Dodd-Frank and SEC rulemakings, many advisers to hedge and private equity funds, which were previously exempt from registration, will need to register as investment advisers with the SEC, comply with the Investment Advisers Act, create compliance programs, file new reports, and open their books to the SEC for review — all by March 30, 2012. Even some advisers that are exempt from full-blown registration (such as advisers to venture capital funds and smaller funds) will still need to file reports with the SEC. SEC Chairman Mary Schapiro said that the rules “will give the [SEC], and the public, insight into hedge fund and other private fund managers who previously conducted their work under the radar and outside the vision of regulators.”

Open questions remain, however, especially with respect to the data that will be required from hedge fund advisers on new Form PF (intended to evaluate systemic risk), how the SEC will oversee the many hundreds of new advisers that will register with it, and whether the influx of new registrants will give greater claim to the need for some type of alternative oversight regime such as a self-regulatory organization for advisers. Additional rules still to come include recordkeeping requirements for “exempt reporting advisers.”

Compensation: Changing incentives for risk-taking

Regulators proposed rules that would prohibit covered financial institutions (those with \$1 billion or more in total consolidated assets) from offering any type of incentive-based compensation that, in the regulators’ determination, provides excessive compensation or could expose the institution to inappropriate risks that could lead to material financial loss. Larger covered financial institutions (those with \$50 billion or more in total consolidated assets) would face additional requirements to defer incentive-based compensation for executive officers. Final rules are expected in year two, but what remains to be seen is how the rules will affect the design of compensation arrangements at larger financial institutions, and what impact this will have on the competitive landscape globally and across industry sectors.

Broker-dealers: A uniform fiduciary duty?

Dodd-Frank required the SEC to conduct a study on the duty of care owed by broker-dealers and investment advisers when providing advice about securities to retail customers, and authorized the SEC to effect rules to change the standard of care for broker-dealers. In January 2011, the SEC released its *Study on Investment Advisers and Broker-Dealers*, which concluded that retail investors generally are not aware of the different regulatory requirements and standards of care governing broker-dealers and investment advisers, and recommended a “uniform fiduciary standard” for investment advisers and broker-dealers.

Many open questions remain, however, as to how such a duty would be defined in the context of the broker-dealer model, with its commission-based compensation structure, sales of proprietary products, principal trading, and other features. The SEC has indicated that it intends to propose rules outlining a uniform fiduciary duty, as appropriate, sometime before the end of the year.

Thriffs and their holding companies get new regulators and supervisors

On July 21, 2011, the regulatory and supervisory authorities which the Office of Thrift Supervision had exercised over thriffs and their holding companies were transferred by law to the Office of the Comptroller of the Currency (federal thriffs), the FDIC (state thriffs),

and the Federal Reserve (thrift holding companies). The agencies have made outreach efforts to help the institutions prepare for the change, which will also involve significant changes in regulatory reporting requirements, as thrifts begin filing the bank Call Report in the first quarter of 2012. More demanding will be the filing of Bank Holding Company regulatory reports by thrift holding companies. The Federal Reserve has recently indicated that it will phase-in full BHC regulatory reporting for SLHCs over a two-year period beginning no sooner than March 31, 2012. It has also proposed exempting certain institutions from BHC reporting that are large commercial SLHCs with very small thrifts as well as insurance companies that only prepare reports based on Statutory Accounting Principles. Also, the Federal Reserve has indicated in recent guidance that it will take more of a discovery approach to supervision of thrift holding companies during the first exam cycle, including providing “indicative” BHC supervision ratings.

New incentives for whistleblowers

Dodd-Frank’s whistleblower provisions created a system of financial incentives and protections to encourage those with information about possible violations of the securities or commodities laws to bring their complaints to the SEC or CFTC. Whistleblowers can receive between 10% and 30% of any amounts obtained in a successful regulatory enforcement action with sanctions of \$1 million or more brought as a result of the tip.

The goal of the new whistleblower program as defined in the SEC’s final rule — “getting high-quality, original information about securities violations directly into the hands of Commission staff” — is likely to be achieved, as we understand that the number and quality of tips and complaints received by regulators increased significantly in year one. The impact on companies’ existing compliance programs is a year two issue, as firms assess their existing compliance programs, internal reporting mechanisms, as well as their processes and strategies for conducting investigations.

Credit ratings

To reduce reliance on credit ratings, Dodd-Frank required that regulators remove them from the myriad of statutes that use credit ratings as eligibility criteria and develop alternative criteria. In year one, the SEC adopted final rules removing credit ratings as criteria for short form registration (Forms S-3 and F-3), with a temporary three-year grandfather provision, though additional references remain in the securities laws. Banking regulators are also working on developing alternative standards to replace credit ratings in banking regulations, but new standards are proving difficult. In the “easier said than done” category, the FDIC warned that if the standards are too detailed, they could create a compliance burden for banks, but if they are not detailed enough, they may not accurately distinguish the credit risk of a particular investment. The regulators also noted that taking steps to reduce the reliance on credit ratings will complicate the task of harmonizing bank capital requirements internationally.

Securitization

The proposed credit risk retention rule mandated under Dodd-Frank has proven extremely controversial. The comment period expired on August 1, 2011—an extension from the original proposal. Dodd-Frank required regulators to establish a “qualified residential mortgage” (QRM) category of loans that would be exempt from Dodd-Frank’s risk retention (“skin in the game”) requirements once they are determined to be well underwritten, low-risk, and high-quality. In March, federal banking regulators proposed to set a 20% down-

payment requirement, among other criteria, to exempt a loan from the risk retention requirements.

The proposal has been criticized by an array of stakeholders, including lawmakers from both parties, the American Bankers Association, and a coalition of consumers, lenders, homebuilders, realtors, and civil rights advocates who contend that the proposed QRM definition would restrict credit and adversely affect borrowers, thereby compromising economic recovery. Senator Bob Corker (R-TN) wrote to Treasury Secretary Timothy Geithner arguing that “a rule that allows for a more sophisticated trade-off between down payment and other risk-mitigating factors such as documentation, type, or credit score would still materially improve underwriting quality but would not represent such a blunt change to market conditions.”

The other major piece of securitization reform, proposed revisions to SEC Regulation AB’s registration, disclosure, and reporting requirements for asset backed securities and other structured finance products (“Regulation AB II”), has been put on hold by the SEC while it focuses on meeting other Dodd-Frank rulemaking deadlines. SEC Chairman Mary Schapiro recently announced that portions of the proposed rules most likely will be reconsidered and re-released in the near future to account for concerns already addressed under Dodd-Frank.

The new kids on the block: The Consumer Financial Protection Bureau

The most immediate question surrounding the new Consumer Financial Protection Bureau (CFPB) has related to the supervisory approach it would pursue. In July, the CFPB began to answer that question by outlining the approach it will take in supervising 111 depository institutions with total assets over \$10 billion. The approach outlined is generally consistent with the approach taken by the prudential regulators: most institutions will be subject to periodic examinations, while other larger, more complex organizations will have year-round teams dedicated to their supervision. The CFPB’s supervisory staff is primarily comprised of experienced examiners gathered from existing agencies, with a variety of regulatory backgrounds.

More insight will come soon as the CFPB has promised to put an initial phase of its examination manual on its website and to solicit feedback and suggestions. The first phase of the CFPB manual will provide insights into its supervisory philosophy, areas of emphasis, and expectations for institutions and their compliance programs. While it appears clear that the CFPB has developed a strategy for the nation’s largest banks, it is unclear how the supervisory process will be applied to other organizations under its purview, and how this strategy will integrate with other prudential regulators. A more defined supervisory strategy is likely after the Bureau’s first director is approved.

Insurance: A new federal presence

The new Federal Insurance Office (FIO) opened in year one, and is likely to find its identity and communicate its intentions in year two. Be on the lookout for new FIO director Michael McRaith (formerly the Director of the Illinois Department of Insurance) and his staff to spread a new aura of federal interest over the state-regulated insurance industry. The FIO’s first charge is to report on:

- Any actions taken by the office regarding the preemption of state insurance laws;
- An examination of the insurance industry; and
- How to modernize and improve the system of insurance regulation in the United States.

Some industry representatives have expressed concern that the FIO has been tasked with producing a report that may call for it to be granted more authority over the industry it monitors. Additionally, the FIO's information-collection efforts could stretch beyond the industry to possibly put more focus on gathering data about issues such as underserved communities and consumer access to affordable insurance products. It is not clear that such information is currently being collected or even how such information could be developed. Other questions about the FIO's new role include how it will interact with the industry and how it will exercise its responsibilities in the context of a state-regulated industry.

In addition to the new FIO, insurance companies will keep an eye on the FSOC. Three seats on the FSOC are allocated to insurance representation. Uncertainty over the SIFI designation criteria and its regulatory implications carries concerns for the insurance industry. Insurers seem to be adamant, largely through their trade associations, that core activities of an insurance firm do not create systemic risk, but rather, insurers absorb more risk than they create. Stay tuned as the battle over who's in and who's out takes on industries unused to federal financial regulatory reach.

As we look back at Dodd-Frank year one, we can see the themes ahead for year two, addressing the unfinished business of Dodd-Frank as we describe here. In addition, we expect to see the beginning of Dodd-Frank's cumulative impact as final rules are adopted and implementation begins. In this next phase, firms with an organized response plan and nimble, active teams will manage through the dual challenge of operating their businesses in an uncertain economic environment while redesigning them to fit new regulatory constructs and opportunities.

At PwC, our Financial Service Regulatory team has expertise in the operations, compliance, business, and regulatory challenges arising in every major financial service sector: banking, securities, derivatives, insurance, and asset management. If you have questions on any of these topics, please reach out to your PwC contact.

"Fasten your seat belts. It's going to be a bumpy [year]." Margot Channing [Bette Davis] in All About Eve

Additional information

If you would like additional information on Dodd-Frank or about PwC's Financial Services Regulatory Practice, please contact:

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