Dodd-Frank Effects Greatest Changes to Financial Services Regulation Since the Great Depression©

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Sometime in July, the Dodd-Frank Wall Street Reform and Consumer Protection Act (**Dodd-Frank**), a sweeping regulatory reform bill, will become law.

Dodd-Frank is intended to address perceived deficiencies and gaps in the regulatory framework for financial services in the United States, reduce the risk of bank failures and provide new regulatory resources to prevent or ameliorate future financial crises. Dodd-Frank attempts to do this through provisions that stretch over the entire financial regulatory landscape, including provisions for monitoring and reducing systemic risk, reallocation of federal regulatory authority, and the creation of a consumer protection agency to regulate financial products and services.

Notwithstanding its more than 2,300 pages, Dodd-Frank is a work-in-progress. The Act will require numerous rules to implement and clarify its provisions, many of which will not be completed for more than a year, as well as a plethora of studies which regulators will use in crafting additional regulatory changes. Regulators will then be faced with the Herculean task of interpreting and implementing the Act and regulations.

In addition, additional legislation is on the horizon since Dodd-Frank does not attempt to reform what many believe to be a root cause of the financial crisis: the failure of the housing market due in significant part to institutional failures by the Federal Home Loan Mortgage Corporation (commonly called Freddie Mac) and the Federal National Mortgage Association (commonly known as Fannie Mae). Financial institutions also face additional regulatory action by international bodies, including new risk-based capital and leverage requirements as part of the Basel III accord now being negotiated.

The challenge for financial firms and businesses generally will be to adjust their business models to survive and thrive in the new regulatory environment. Although some early predictions are possible, winners and losers in the regulatory reform environment will likely not be known for several years.

Given the vast scope of Dodd-Frank and the critical details that will be provided by rulemaking, this article provides only an overview.

Systemic Risk and Financial Stability

Dodd-Frank creates a new framework for overseeing systemic risk. It establishes the Financial Stability Oversight Council (the **Council**) tasked to identify and manage systemic risks in the financial system. The Board of Governors of the Federal Reserve System (the **Fed**) has primary

responsibility for supervision and regulation of systemically significant institutions. In addition to bank holding companies (BHCs), non-bank financial companies will be subject to heightened capital and prudential standards if deemed systemically significant. Although Dodd-Frank does not break-up integrated financial institutions, *a la* the Glass-Steagall Act, it does authorize regulators to restrict the size, growth and activities of systemically significant companies, and, in some circumstances, order the divestiture of certain activities or operations. Under the Volker Rule, banks will operate under new restrictions on some types of proprietary trading and their sponsorship or investment in private equity and hedge funds. In addition, Dodd-Frank significantly modifies capital requirements of depository institution holding companies, including prohibiting the use of trust preferred securities as Tier 1 capital, and institutes a "contingent" capital requirement, where financial institutions may be required to convert debt into equity under some circumstances.

Liquidation of Nonbank Financial Institutions

Dodd-Frank permits the U.S. Treasury Secretary to subject a financial company to a special orderly liquidation process administered by the Federal Deposit Insurance Corporation (**FDIC**) when it is in default or in danger of default and where such default presents systemic risk to U.S. financial stability, in lieu of liquidation under the U.S. Bankruptcy Code. Banks remain subject to the insolvency procedure provided under the Federal Deposit Insurance Act.

Private Equity and Hedge Fund Registration

Dodd-Frank requires a broader range of advisers to private funds (but significantly excluding advisers to venture capital funds) to register with the Securities and Exchange Commission (**SEC**) and maintain certain records and reports subject to SEC inspection, as well as subjecting registered advisers to periodic inspections. Both registered and non-registered advisers are subject to new recordkeeping and reporting requirements, providing regulators with an insight into certain aspects of private funds.

Securitization Regulation

Dodd-Frank imposes a 5% risk-retention requirement applicable to originators and securitizers of securitization transactions, including, it appears, loan syndications. It also imposes additional disclosure and reporting requirements for issuers of asset-backed securities

Derivatives Regulation

Dodd-Frank creates a framework for regulation of swaps and other over-the-counter derivatives, as well as many swap market participants and facilities. It requires the Commodities Futures Trading Commission (**CFTC**) and the SEC to establish capital and margin requirements and business conduct standards for swap dealers and major swap participants. Such swaps will be subject to mandatory centralized clearing and trading. Dodd-Frank also imposes significant limitations on certain swap activities of banks, but permits banks to continue to engage in many other forms of swap activities.

Corporate Governance; Executive Compensation

Dodd-Frank imposes additional regulation of compensation paid by “covered financial institutions,” including banks, BHCs, broker-dealers, investment advisers and potentially foreign institutions, prohibiting arrangements that encourage inappropriate risks. U.S. public companies are also subject to a non-binding “say on pay” by their shareholders at least once every three years, as well as a providing shareholders with a “say on pay” regarding golden parachute compensation paid to executives. In addition, public companies will be required to have a compensation committee composed solely of independent directors, and such committee will have authority and funding to hire independent advisers. Dodd-Frank includes additional executive compensation provisions, including a “claw back” of executive compensation based on erroneous facts, and other corporate governance provisions affecting public companies.

Consumer Protection

Dodd-Frank creates an independent Bureau of Consumer Financial Protection (**BCFP**) within the Fed. The BCFP will develop rules applicable to both bank and nonbank companies that offer consumer products and services such as credit cards, mortgages, pay day and other loans (but notably excluding auto loans) and will enforce compliance with such rules.