ALERTS AND UPDATES

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010: Congress Enacts Sweeping Financial Reform

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Duane Morris has issued further Alerts *on many of the broad topics addressed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, accessible at* www.duanemorris.com/FinancialReform.

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act") became law. The U.S. Congress designed the Act to address what it perceived to be a vast number of failures that led to the worst financial crisis since the Great Depression. The Act contains sweeping reform of many aspects of the greater financial system in the United States. It affects the banks, investment funds, insurance companies, investment advisors, corporations and credit-rating agencies that operate within the financial system as well as the regulatory bodies that oversee the system itself. From the elimination of the decades-old U.S. Office of Thrift Supervision and the creation of new regulatory bodies in its place to the required registration of advisors to private investment funds, the Act also changes the nature, number and identity of the agencies that regulate and the institutions that are regulated.

The Act requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and its participants, and more than 250 instances of rulemaking. The most focused period of this regulatory activity is the next 18 months. Congress has given the agencies considerable discretion in designing the final rules, such that the eventual impact of the Act may be difficult to foresee from its text. However, regulations are likely to be adopted in stages, which may afford market participants the opportunity to analyze each successive regulation and adopt new procedures and behavior where required.

The Act addresses the following topics; for further information on a particular topic, please click on its hyperlinked title to access a detailed *Alert*:

1. The Regulation of Derivatives and Swap-Trading Provisions**.**
   The Act provides for sweeping reforms that include substantial regulation of the over-the-counter (OTC) derivative market. Financial institutions that fit within the Act's definition of swap dealer or major swap participant will be subject to new requirements that could include: registration, capital and margin, reporting and recordkeeping, as well as new business-conduct standards that prohibit such entities from dealing in "abusive" swaps. The new requirements will require insured financial institutions to push out many derivatives to separately capitalized affiliates as well as prohibit the federal government from bailing out swap dealers or major swap participants. Participants in derivative trades may also be required to clear many or all of their swaps through a central clearing house. The Act divides oversight jurisdiction of the derivative market between the U.S. Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC and, collectively with the SEC, the "Commissions") and also delegates to the Commissions the authority to promulgate rules and regulations to govern the derivative markets. Thus, the effect of the Act on derivative practices may depend substantially on the enactment and implementation of such rules and regulations.

2. The Volcker Rule and Improvements in the Regulation of Banking Entities and Nonbank Financial Companies Supervised by the Board of Governors of the Federal Reserve System.

   Under section 619 of the Act, known as the "Volcker Rule," banking entities, including insured depository institutions, bank holding companies and their bank and nonbank affiliates or subsidiaries, will no longer be permitted to engage in "proprietary trading," defined as engaging for the trading account of an entity in any transaction to purchase or sell a security. A banking entity will be permitted to make and retain an investment in hedge funds and private equity funds for the purposes of establishing those funds and providing them with sufficient initial equity to permit them to attract unaffiliated investors, or for the purpose of making a *de minimis* investment in such funds. However, each investment made for the purpose of establishing such a fund must be reduced to not more than three percent of the total ownership interest in that fund within one year after the fund's date of establishment, and all of a banking entity's investments in hedge funds and private equity funds, in the aggregate, must be "immaterial" (as that term will be defined by rule) and in no event exceed three percent of the banking entity's Tier 1 capital. Except as otherwise specified, a banking entity will not be permitted to act as a general partner of, or sponsor, any hedge fund or private-equity fund. Nonbank financial companies supervised by the Board of Governors of the Federal Reserve System that, except as otherwise permitted, engage in proprietary trading, or that take or retain an equity or other ownership interest in or sponsor a hedge fund or private-equity fund, will be required to satisfy additional capital requirements as if such nonbank financial companies were banking entities. Regulations to be issued by the Federal Reserve Board, the SEC and the CFTC will be necessary to carry out the provisions of the Volcker Rule.

3. Too-Big-to-Fail Bailout Avoidance Provisions.

   The Act establishes a process by which the FDIC oversees the orderly liquidation of failed or failing financial companies whose potential collapse may constitute a risk to the U.S. financial system as a whole. In establishing an orderly liquidation fund, it also prevents the use of any taxpayer funds for such liquidation. These mandates respond to concerns that federal regulators had insufficient authority over nonbank financial institutions during the 2008 financial crisis and that the behavior of too-big-to-fail nonbank institutions has inappropriately drained away taxpayer dollars. These systemically significant institutions can now be liquidated under the Act's new procedures rather than under existing bankruptcy laws. While the Act provides key new tools for federal authorities, the Act also appears to create uncertainty on whether a company would be subject to an FDIC-controlled receivership action or a chapter 7 or 11 liquidation or reorganization. In addition, the Act permits the Board of Governors of the Federal Reserve System, in certain instances, to break up bank holding companies with total consolidated assets of $50 billion or more as well as nonbank financial companies that pose a "grave threat" to U.S. financial stability, even if such institutions are not insolvent.

4. Creation of the Consumer Financial Protection Bureau.

   Title X establishes the Bureau of Consumer Financial Protection. The Bureau will have the authority to regulate and enforce substantive standards for any person that engages in the offer or sale of a financial product or service to any consumer. The Bureau is also granted authority to supervise covered persons, such as large banks, savings associations and credit unions that offer consumer financial products and services and the power to enforce federal consumer financial laws. To that end, the Bureau is authorized to issue rules, orders and guidance to implement federal consumer financial law and bring enforcement actions to uphold federal consumer financial law.

   The Bureau will have the power to enforce consumer financial laws in a number of ways, including assessing civil money penalties which can range up to $1 million per day in some cases, disgorgement for unjust enrichment, and restitution. The Bureau will also have the power to institute civil investigations, demand documents and information, issue subpoenas, conduct hearings and adjudication proceedings, issue cease-and-desist orders, and commence civil actions. The Bureau is tasked to: (1) conduct financial education programs; (2) collect and forward complaints to agency regulators; and (3) collect, monitor and publish information about the functioning of the market for consumer financial products. The rules to be implemented by the Bureau under this Act will have a significant impact on the financial industries that market to consumers.

5. Registration of Advisors to Private Investment Funds and Pools, and of Small Advisory Firms.
   By eliminating the decades-old exemption from investment advisor registration for small advisory firms and for advisors to private-investment funds, the Act will require thousands of firms to register as investment advisors. Beyond the fact of registration, these firms will become subject to the pervasive regulatory scheme that limits incentive-based compensation, requires detailed reporting and documentation, and imposes other restrictions on otherwise-common business practices. In addition, the Act requires the collection of systemic-risk data on such private funds, including portfolio and trading information.

6. Creation of the Federal Insurance Office and the Financial Stability Oversight Council.
   The Act creates the Financial Stability Oversight Council, composed of existing regulators, to monitor and address systemic risks to the United States' financial stability. The Act also creates the Federal Insurance Office within the Treasury Department to monitor the insurance industry and to work with the Financial Stability Oversight Council to identify insurers that could impact U.S. financial stability.

7. Capital Requirements for Financial Institutions.
   Title I of the Act implements increased oversight of the capital requirements of financial institutions, requiring: (i) appropriate minimum leverage capital and risk-based capital levels on a consolidated basis for insured depository institutions, depository-institution holding companies and nonbank financial companies supervised by the Board of Governors of the Federal Reserve System; (ii) a study, and a report to Congress, relating to the feasibility of a contingent capital requirement for nonbank financial companies supervised by the Board of Governors and large, interconnected bank holding companies; and (iii) annual analyses by the Board of Governors that evaluate whether nonbank financial companies supervised by the Board of Governors and larger bank holding companies have the capital, on a consolidated basis, necessary to absorb losses as a result of adverse economic conditions, and annual or semi-annual stress tests by the entities themselves.

   Title VI of the Act requires that bank holding companies and savings and loan holding companies that wish to expand the financial services of their bank subsidiaries are well capitalized and well managed, and imposes a heightened standard of review regarding the capitalization of a bank resulting from a merger or acquisition. Title VI also requires bank holding companies and savings and loan holding companies to serve as a source of financial strength for their subsidiaries that are depository institutions, and, for an insured depository institution that is not the subsidiary of a bank holding company or a savings and loan holding company, that any entity that directly or indirectly controls the insured depository institution serve as a source of financial strength for the depository institution.

8. Modifications to the U.S. Federal Reserve's Emergency Lending Authority.
   The Act limits the Federal Reserve's ability to lend to individual companies outside a program or facility that provides for broad-based eligibility, which may prevent the possibility of cherry-picking one company over another on an individual basis. Furthermore, the revised section 13(3) prohibits the Federal Reserve from lending to

insolvent borrowers. The Act makes similar changes to the FDIC's emergency lending power, whereby the FDIC must create a widely available program to guarantee obligations of solvent insured depository institutions or holding companies once a determination has been made that a liquidity event exists. In an effort to ensure accountability of the Federal Reserve, the Act requires that the U.S. Government Accountability Office (GAO) audit the loans and other financial assistance authorized under the Federal Reserve's section 13(3) emergency lending authority.

9. Consumer Financial Protection Act of 2010 Institutes First Federal Regulation of Debit Card Interchange Fees**.**
The Act represents the federal government's first significant foray into the interchange fees on card transactions. The Federal Reserve Board has nine months to promulgate regulations intended to make interchange fees "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." The expectation appears to be that direct regulation of interchange fees on debit-card transactions would exert indirect pressure on the fees relating to credit cards. The Act also expands the Electronic Fund Transfer Act to put limitations on agreements between merchants and payment networks. Networks may no longer use their agreements to prevent merchants from offering discounts to consumers who pay with debit cards and other forms of payment that involve lower fraud-risk and, hence, lower cost to the merchant and others in the process. The Federal Reserve Board is also required to establish long-needed fraud-reduction standards and to create incentives for issuers, merchants and networks to comply with them.

10. Corporate Governance and Executive Compensation Provisions for Public Companies**.**
The corporate governance provisions in Title IX require shareholder proxy access, expand compensation disclosure, institute say-on-pay votes, prohibit brokers from voting street-name shares on say-on-pay and other significant matters, mandate membership and operation of compensation committees, strengthen proxy disclosure, and amend securities transaction reporting under sections 13 and 16 of the Securities Exchange Act of 1934. The Act also vests broad rule-making discretion in the SEC, and therefore the exact impact of the Act will not be known fully for some time.

11. Mortgage Reform and Anti-Predatory Lending Act**.**
Title XIV of the Act sets forth minimum underwriting standards for home mortgages and requires lenders to ensure a borrower's credit-worthiness by verification of income, employment status and credit history. The Act also prohibits steering incentives and restricts other forms of compensation to mortgage brokers and lenders. Additional protections are given to borrowers with "high cost mortgages"; certain prepayment penalties are prohibited or restricted; and an Office of Housing Counseling will be created in the Department of Housing and Urban Development.

12. Municipal Securities**.**
The Act establishes the Office of Municipal Securities within the SEC, to administer the rules of the SEC concerning the practices of municipal-securities brokers, dealers and advisors and to coordinate rulemaking and enforcement actions with the Municipal Securities Rulemaking Board (MSRB). The Act requires the registration of municipal advisors and imposes a fiduciary duty on such advisors when advising municipal issuers, which would subject such advisors to MSRB rules enforced by the SEC. The Act changes the composition of the MSRB's board of directors so that the majority of members are independent of municipal-securities brokers, dealers and advisors.

13. Credit Rating Agencies**.**
The Act responds to the part credit-rating agencies played in the recent financial crisis. Regulations on this subject

are to be promulgated by the SEC within a year of the Act's enactment. The SEC will have a newly created Office of Credit Ratings to oversee the (currently 10) Nationally Recognized Statistical Rating Organizations (NRSROs). The regulations appear to be meant to achieve transparency around the NRSROs' management and rating processes, internal controls over the consistent implementation of the rating process, and avoidance of the conflicts of interest that have beset the agencies. There will be a comprehensive application process and a requirement for annual recertification of the NRSROs. The provision that garnered reactions from three of the agencies within hours of President Obama's signing of the Act relates to an amendment to the Exchange Act allowing investors to bring private suits against rating agencies for a knowing or reckless failure to: (1) follow their own published methodologies for evaluating credit risk or (2) verify independent sources of information upon which they relied. Three rating agencies immediately announced that they would stop rating bonds, while a fourth expressed no concern about being made accountable for its actions.

14. New Whistleblower Incentives and Protections, and More Enforcement Expected.
    The Act includes "bounty hunter" provisions to increase the voluntary reporting of securities and commodities violations. Congress did so by significantly enhancing whistleblower rewards and protections. These provisions may pose new and considerable challenges to publicly traded companies – including heightened FCPA risks and costly compliance burdens. The SEC recently paid a whistleblower a $1 million reward in the *Pequot* matter. Combined with the federal law that criminalizes retaliation against an employee who provides confidential information to the government, or who purloins corporate documents to turn them over to the government, companies may now want to consider assessing how they conduct their business activities, measured by a focused risk metric.

Conclusion

The Act is vast in size and scope, and affects those who operate within the financial system as well as those who regulate it. It addresses both the discrete and the systemic. However, the extent to which the Act truly achieves its goals, addresses the causes of the financial crisis and is able to prevent or mitigate a future crisis remains to be seen. The full impact of the Act will not be apparent until the regulatory agencies have completed the extensive rulemaking required by its terms.

About Duane Morris

Duane Morris has an online **Financial Services Reform Center** – www.duanemorris.com/FinancialReform – which includes videos and the firm's comprehensive series of *Alerts* analyzing the provisions of the Act and emerging policies, as well as links to relevant government websites. Duane Morris' attorneys will be monitoring the rules and regulations released under the Act, as well as the regulatory agencies' interpretive guidance. For subsequent *Alerts* on these and other topics, please revisit www.duanemorris.com and www.duanemorris.com/FinancialReform.

For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact Robert P. Bramnik, Joel N. Ephross, Laurence S. Lese, George D. Niespolo, Marvin G. Pickholz, Loren Schechter or the attorney in the firm with whom you are most regularly in contact.